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IN THE

Supreme Court of the United States

October Term, 1971

70-273

No. ~~1818~~

JOHN F. KAPPEL and EDNA I. KAPPEL,
Petitioners,

v.

UNITED STATES OF AMERICA.

ESTATE OF WILLIAM J. KAPPEL, Deceased, by SARAH M. KAPPEL and WILLIAM D. KAPPEL, Executors, and SARAH M. KAPPEL,
Petitioners,

v.

UNITED STATES OF AMERICA.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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INDEX.

	PAGE
Opinions below	2
Jurisdiction	2
Question presented	3
Statute and regulation involved	3
Statement	5
Reasons for granting the writs	11
Conclusion	30
Appendix A	1a
Appendix B	13a
Appendix C	15a
Appendix D	33a
Appendix E	37a
Appendix F	38a
Appendix G	39a

CITATIONS.

CASES:

Burnet v. Sanford & Brooks Co., 282 U. S. 359, 365-366, 51 S. Ct. 150, 152 (1931) 27
Charleston and Western Carolina Railway Co. v. Burnet, 50 F. 2d 342 (C. A. D. C.) 28
Chicago, R. I. & P. Railway Co. v. Commissioner, 47 F. 2d 900 (C. A. 7), certiorari denied 284 U. S. 618 . 28
Commissioner v. Estate of Bosch, 387 U. S. 456, 87 S. Ct. 1776 (1967) 11, 16
Community Services, Inc. v. U. S., 422 F. 2d 1353, 1359 (Ct. Cl. 1970) 23, 24, 25
First Trust Company of St. Paul v. U. S., 321 F. Supp. 1025 (U. S. D. C. Minn. Nov. 18, 1970) 18
Garner v. Girard Trust Bank, 442 Pa. 166, at page 169 (March 18, 1971) 11, 15
Glauser Estate, 350 Pa. 192, 38 A. 2d 64 (1944) 13, 14

PAGE

Joseph S. Pike, 44 T. C. 787 Acq. 1968-2 C. B. 2 21
Maloney v. Glosser, 427 Pa. 548, 235 A. 2d 607 (1967) 12
William L. Mitchell, 52 T. C. 170 (1969) 21
North American Oil Consolidated v. Burnet, 286 U. S. 417, 424, 52 S. Ct. 613, 615 (1932) 16, 27, 28
Northrop v. Graves, 19 Conn. 548 (235 Pa. at 530) 13
Reilly v. Walker Brothers, 425 Pa. 1, 229 A. 2d 457 (1967) 14, 15, 16
Stone v. White, 301 U. S. 532, 535, 57 S. Ct. 851 (1937) 29
Union Trust Co. of New York v. Gilpin, 235 Pa. 524, 525, 530, 84 A. 448 (1912) 12
U. S. v. Skelly Oil Co., 394 U. S. 678, 683, 89 S. Ct. 1379, 1383 (1969) 21, 27, 28, 29

STATUTES AND REGULATION:

Internal Revenue Code of 1954:
Section 162 .....4, 39a
Section 165 .....4, 19, 40a
Section 401 .....4, 10, 19, 41a
Section 501 .....4, 19, 22, 43a
Section 503 .....4, 10, 19, 21, 44a
Section 1341 .....3, 5, 17, 20, 28, 46a
Section 2039 .....4, 21, 47a
Section 2517 .....4, 21, 49a

INTERNAL REVENUE RULINGS, ETC.

G. C. M. 16730 (General Counsel Memorandum) .4, 21, 51a
Revenue Ruling 55-297 .....4, 56a
Revenue Ruling 58-456 .....4, 21, 57a
Revenue Ruling 67-9 .....4, 22, 66a
Revenue Ruling 68-662 .....4, 68a
Revenue Ruling 70-315 .....4, 23, 71a

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PETITION FOR WRITS OF CERTIORARI

Petitioners, JOHN F. KAPPEL, EDNA I. KAPPEL, Estate of WILLIAM J. KAPPEL, Deceased, by SARAH M. KAPPEL and WILLIAM D. KAPPEL, Executors, and SARAH M. KAPPEL, pray that Writs of Certiorari issue to review the judgments of the United States Court of Appeals for the Third Circuit, dated February 1, 1971, and made final by denial of petition for rehearing on March 19, 1971.

Opinions Below

The Opinion of the United States Court of Appeals for the Third Circuit, decided February 1, 1971 (Appendix A); is reported in 437 F.2d 1222. The Petitioners' petition for rehearing was denied on March 19, 1971 (Appendix B). The opinion of the United States District Court for the Western District of Pennsylvania, filed March 22, 1968, is reported in 281 F. Supp. 426 (Appendix C). The Memorandum Opinion of the United States District Court for the Western District of Pennsylvania, denying Petitioners' motions to amend the judgments and for a new trial, filed January 16, 1970, is not officially reported (Appendix D). The judgments from which appeals were taken to the United States Court of Appeals for the Third Circuit, were filed by the United States District Court for the Western District of Pennsylvania on January 19, 1970 (Appendix E and Appendix F).

In this Petition references to the pages of the Record in the Court of Appeals, certified to this Court (2 vols., pp. 1a through 1704a) will be referred to by the initial "R". References to the Appendix attached to this Petition (1a through 72a) will be by the preface "App.".

Jurisdiction

The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1). The judgments sought to be reviewed were entered by the United States District Court for the Western District of Pennsylvania on January 19, 1970. (Appendix E and Appendix F.) The judgments of the Court of Appeals for the Third Circuit, affirming the District Court judgments were entered February 1, 1971 (Appendix A). A joint Petition for Rehearing was denied on March 19, 1971 (Appendix B).

Question Presented for Review

Whether petitioners, having restored $560,835 to employee pension trusts in 1960 after having been taxed thereon as income in the years of receipt and being advised that it was their duty to repay that money to the trusts because it had been received therefrom illegally, were entitled to deduct the repayments from gross receipts in computing their taxable incomes for the year of repayment and receive tax refunds of $382,325; or whether, as the court below held, such deductions could not be taken and the petitioners could have neither the money nor the refunds because the petitioners, in spite of their violations of the trusts, of their fiduciary duties to the trusts and of their fiduciary duties as directors and officers of the settlor-employers, were nevertheless not obligated as beneficiaries of the trusts to restore thereto the moneys they illegally received.

Statute Regulations and Revenue Rulings Involved

Internal Revenue Code of 1954, As Amended:
26 United States Code

(Statute Sections and USC Sections are Identical)

Section 1341: Computation of tax where taxpayer restores substantial amount held under claim of right

(a) General rule.—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years). * * *

Section 162—In Appendix G
Section 165—In Appendix G
Section 401—In Appendix G
Section 501—In Appendix G
Section 503—In Appendix G
Section 2039—In Appendix G
Section 2517—In Appendix G

INTERNAL REVENUE RULINGS, ETC.

G. C. M. 16730 (General Counsel Memorandum)—In Appendix G
Revenue Ruling 55-297—In Appendix G
Revenue Ruling 58-456—In Appendix G
Revenue Ruling 67-9 —In Appendix G
Revenue Ruling 68-662—In Appendix G
Revenue Ruling 70-315—In Appendix G

Statement of the Case

The taxpayers in this case, John F. Kappel and William J. Kappel (now deceased), improperly received distributions from four employees' pension trusts and upon threat of assessment by the Internal Revenue Service ("the Service") paid an income tax on the distributions. (The wives of the taxpayers are parties simply because joint income tax returns were filed by each couple.) Proceeding to restore the distributions to the respective pension trusts, the taxpayers then deducted on their 1960 returns the part of the income tax paid in prior years by reason of the inclusion in gross income of the pension plan distributions, as determined under the "claim of right computation" provided in Section 1341 of the Internal Revenue Code. The Internal Revenue Service disallowed the deduction. The taxpayers paid the contested tax and then brought these suits for refunds.

The issue raised on this appeal is whether the appellants are entitled to a refund of the taxes paid, and this in turn depends primarily on whether they had a "legal obligation" to repay the amounts improperly received from the pension trusts so as to qualify for the deduction provided by Sec. 1341 of the Internal Revenue Code of 1954.

Taxpayers were officers, directors, principal stockholders and employees of four corporations: Busch's Kredit Jewelry Company, Inc. of New York, Busch's Jewelry Company, Inc. of New York, the William J. Kappel Company, and the Busch Kredit Jewelry Company of Chicago, Illinois (R. 258-263, 664). Two of these corporations have maintained employee pension plans since 1936 and the other two have done so since 1941. Taxpayers were participating employees in all plans. Taxpayers were also members

of the board of trustees of each trust; the trustees were elected by the board of directors of each corporation. Each trust was funded by the settlor corporation and the trustees contracted for separate annuity policies on each participating employee, including taxpayers, through ten different life insurance companies. The ownership of each annuity policy on each beneficiary of the pension trusts was vested in the trustees of the particular pension trust of the corporation employing the particular beneficiary (R. 664, 985-1025).

Each pension trust contained provisions to the effect that (R. 664-665, 985-1025):

(a) Pension benefits could not be paid to a beneficiary in one lump sum;

(b) No beneficiary had any power of anticipation of the payments provided in the annuity policy;

(c) No sale, assignment, transfer, anticipation, commutation, or alienation could be made by a beneficiary, and all payments were required to be made to a beneficiary personally, or to a beneficiary designated to receive benefits at his death;

(d) When an employee reached the age of 65, or on an earlier retirement, the trustees were to arrange to have the benefits of his annuity paid to him in accordance with the options of the policy;

(e) The trustees reserved the right in their discretion to terminate the trust or to amend it, except that they could not deprive any employee of any rights to which he had become vested under the pension trusts.

The pension trusts were originally proposed to taxpayers' corporations by Jules Polachek, a Pittsburgh life in-

surance underwriter who held himself out as, and was generally reputed to be, an expert in the field of corporate pension plans. The trustees relied upon his advice and assistance at all times. He prepared the trust agreements and provided for the purchase by the trustees of the annuities for each beneficiary from life insurance companies that he represented. He also collected corporate and employee contributions, transmitted them to the insurance companies, processed applications, and determined questions of coverage (R. 665).

In 1954, when both taxpayers were over 65 years of age and active in the corporations, Polachek suggested to them that if they, without retiring from employment, would agree to the distribution of the proceeds of the annuity policies held by the trustees for their benefit, and the reinvestment of such benefits in deferred annuities naming members of their families as beneficiaries, they would incur no federal tax liability for income, gift or estate taxes. Relying on Polachek's advice, application was made on behalf of the trustees, signed by taxpayer John F. Kappel or by William D. Kappel (the son of taxpayer William J. Kappel), in their capacity as trust secretaries of the various pension trusts, to the various life insurance companies for the proceeds of the annuities on taxpayers' lives (R. 1026-1050). The applications were processed and forwarded through Polachek. There was no consent, joinder, or formal action by all of the trustees of any pension trust involved, or a majority of them, in such application for the payment of the proceeds of the annuities (R. 665-666).

Each of the ten insurance companies paid the proceeds of the annuity policies upon such application (R. 666). Payment was made by 23 separate checks which, by endorsement were made payable directly to the Dominion

Life Assurance Company or the American United Life Insurance Company in accordance with Polachek's instructions (R. 666, 1051-1063). The checks were delivered to Polachek who forwarded them to the respective insurance companies and secured the issuance of deferred annuity contracts on the lives of members of taxpayers' families according to the respective shares of each taxpayer in such proceeds. Polachek received commissions from the issuing insurance companies as agent (R. 666).

The above transactions occurred during the years 1954, 1955, 1957 and 1958. Neither taxpayer reported the receipt of the proceeds of these pension trust annuities on his federal income tax returns for the years in which the policies were cancelled and the proceeds used to purchase annuities on the lives of members of taxpayers' families (R. 667, 813-897, 910-965).

Late in 1958, agents of the Internal Revenue Service notified taxpayers of their intention to assess deficiencies on their income taxes for the years 1954, 1955, 1957 and 1958 based upon the trust distributions to them. At this time, taxpayers engaged legal counsel and accounting representatives who advised them that the distribution of the pension policy benefits to them violated the provisions of the pension trust agreements which prohibited lump sum payments and which limited the maximum size of monthly installment payments. Counsel advised taxpayers that they were obliged to refund the payments to the pension trusts concerned. Taxpayers' counsel also informed the trustees of the pension plans involved that the proceeds of the insurance policies had been paid to taxpayers contrary to the terms of the pension trust agreements and that they were under a legal duty to require repayment. Upon receipt of this advice, the trustees authorized counsel to take such

action as was necessary to secure restoration of the funds to the pension trusts (R. 667).

Taxpayers, in 1960, with their personal funds and pursuant to the advice of legal counsel, repaid to the trustees the funds withdrawn in 1954, 1955, 1957 and 1958 from the pension trusts. Upon receipt of these funds, the trustees of the Pennsylvania trusts used them to acquire annuities on the lives of taxpayers to be owned and held in the pension trusts. Also, legal counsel secured from the Dominion Life Assurance Company and the American United Life Insurance Company the cancellation of the annuity contracts on the lives of members of taxpayers' families which had been purchased with the funds received by taxpayers from the pension trusts. The two companies also repaid the funds which they had received from taxpayers (R. 668).

In 1961, upon timely filing of their individual income tax returns for the calendar year 1960, taxpayers claimed an overpayment of taxes beyond the amount due, based upon taxes paid upon the funds received from the pension trusts in 1954, 1955, 1957 and 1958, as follows (R. 668-669, 873, 875-877, 950, 952-954):

John F. and Edna I. Kappel	$120,334.18
William J. and Sarah M. Kappel	$261,990.87

Taxpayers' claims here are limited to tax liability which taxpayers have paid on the distributions made to them from the pension funds which are the product of the employer-funded portions of their 1954, 1955, 1957 and 1958 withdrawals. No claim is made in the instant proceedings for any tax paid on other funds received from the pension trusts which were the product of their own payments toward the insurance or annuity policies (R. 669).

These amounts are deemed to have been paid as of April 15, 1961. The balance of the additional tax with respect to the pension trust withdrawals was paid in 1963 (R. 18, 64, 669). On April 10, 1964, taxpayers filed claims for refund with the District Director of Internal Revenue, Pittsburgh, Pennsylvania (R. 15-56, 61-113).

After a trial lasting five days, Judge Weber found in an opinion reported at 281 F. Supp. 426 (W. D. Pa. 1968) that the pension trust agreements had been violated by the improper withdrawals (R. 667; App. 19). But Judge Weber also decided that under Pennsylvania trust law the taxpayers had no legal obligation to return the funds that had been withdrawn from the trusts and, accordingly, rendered a decision for the United States (R. 679-681; App. 30-31). Taxpayers then moved to take additional testimony to show that in 1967 the Service found the original pension trusts all to have been disqualified under Sec. 503(c)(6) of the Code as qualified pension plans within the meaning of Sec. 401 of the Code as of the years in which the improper withdrawals were made (R. 681-609). The trial judge denied the motion for the taking of further testimony because "there was no such threat existing in 1960, either by other beneficiaries who could allege impairment of the trust res, or by those affected by the loss of tax benefits first raised . . ." several years later (R. 754; App. 34).

The court then entered judgments in favor of the Government, and the taxpayers appealed (R. 757-759).

The court below, the Court of Appeals for the Third Circuit, affirmed (App. 2-13). A petition for rehearing was considered by the Court of Appeals but finally denied on March 19, 1971 (App. 14). Hence this petition.

Reasons for Granting the Writs

1. The United States Court of Appeals for the Third Circuit has decided an important state question in a way that is in conflict with applicable state law and the instructions of this court in *Commissioner v. Estate of Bosch*, 387 U. S. 456, 87 S. Ct. 1776 (1967).

In the present case, we respectfully submit, the Court of Appeals and the district court both failed or refused to follow the law of trusts in Pennsylvania as it relates to the enforcement of trusts and especially the requirement that beneficiaries restore to a trust any funds they have received before they were entitled to receive the same or through a mistaken interpretation of the pension plan or because they refused to follow the formal requirements of the plan.

Petitioners filed numerous briefs in the district court in support of their position that the taxpayers as improperly paid beneficiaries or as errant trustees or as businessmen trying to restore their image of fidelity to their employees were required to restore the funds they had improperly received to the employee pension trusts from which they had been paid.

The most recent (after the decision of the court below) pronouncement on this subject by the highest Pennsylvania court, the Supreme Court of Pennsylvania, by whose decision the applicable law is established, as held in *Commissioner v. Estate of Bosch*, above, is *Garner v. Girard Trust Bank*, 442 Pa. 166, at page 169 (March 18, 1971), as follows:

> *"The law is clear with regard to profit-sharing and pension plans.* Even *when the employee* does not contribute to the plan, when he *renders service to an employer who has such a plan in effect, he has a contrac-*

tual right to enforce the plan according to its terms" (Emphasis ours).

During the trial of these cases in the district court, the Supreme Court of Pennsylvania decided *Maloney v. Glosser,* 427 Pa. 548, 235 A. 2d 607 (1967), in which it was held that a retired employee who had been overpaid by $39,000 under misinterpretation of a profit-sharing plan and trust was properly required to restore the $39,000 to the trust. The district court disregarded this case on the ground that it could find no Pennsylvania case where a trust beneficiary had been held liable to repay moneys to a trust unless there was loss to other beneficiaries (R. 679; App. 31). The district court also seemed to believe that the taxpayers could change the terms of the trust to suit themselves as they saw fit and had done so by receiving money from the four employee pension trusts (R. 679-680; App. 30-31).

It seems clear from a reading of *Maloney v. Glosser,* 427 Pa. 548, above, that William Glosser, a retired employee, was required to restore $39,000 to the employee profit-sharing retirement trust because that amount was an overpayment due to the misconstruction of the terms of the plan and trust by the trustees. While the overpayment in that case did affect the amounts payable to other later retiring employees, payment by the errant trustees would have been required at such later date in accordance with the terms of the plan and trust if the retired employee did not restore the $39,000 overpayment.

The decision in the *Maloney* case, above, followed the rule announced and applied by the Supreme Court of Pennsylvania in *Union Trust Co. Of New York v. Gilpin,* 235 Pa. 524, 525, 530, 84 A. 448 (1912), where a trustee was held entitled to recover money mistakenly paid to the wrong beneficiary. The Supreme Court of Pennsylvania

adopted the following rule of law previously announced by Chief Justice Church in *Northrop v. Graves,* 19 Conn. 548 (235 Pa. at 530):

> "We mean distinctly to assert that where money is paid by one under a mistake of his rights and his duty, and which he was under no legal or moral obligation to pay, and which the recipient has no right in good conscience to retain, it may be recovered back in an action of indebitatus assumpsit whether such mistake be one of fact or law; and this we insist may be done both upon principle of Christian morals and the 'common law.'"

A most graphic illustration of the duty, in Pennsylvania, of a beneficiary to repay amounts improperly received, even where the beneficiary could have justified the payment by requesting the payment in writing from the trust, is found in *Glauser Estate,* 350 Pa. 192, 38 A. 2d 64 (1944). There the widow of the testator, who was prime beneficiary and one trustee of the testamentary trust he created, received money from the trust through the trustees paying an obligation she undertook after her husband's death. The will provided in paragraph 8 (350 Pa. at 204) that testator did "empower my Trustees or Trustee to pay and advance to my said wife . . . such amount or amounts from . . . principal of this trust, as in the sole judgment of said Trustees or Trustee, may be reasonably required for [her] proper support, comfort or welfare, . . . My said Trustees or Trustee shall not be responsible for the use of these advances from principal." The trustees paid off the note without a formal request by the widow. The lower court allowed the payment as a proper one, but the Supreme Court reversed, stating (350 Pa. at 205):

> "We think the testator . . . intended to authorize the trustees 'to pay and advance' part of principal on two conditions: (1) Demand by the beneficiary for a

> purpose specified, and (2) subject to the discretion of the trustees to approve or disapprove. . . . Mrs. Glauser did not request an advancement pursuant to paragraph 8, and, in joining in the payment, did not act pursuant to paragraph 8. The assignment of error must be sustained and both accountants surcharged with the amount wrongfully paid."

Surely the *Glauser* case, above, shows that trust instruments cannot be informally altered by the beneficiaries and trustees. Any possible doubt as to this was done away with in the following decisions of the Supreme Court of Pennsylvania, one of which was decided after the decision of the Court of Appeals in this case.

In *Reilly v. Walker Brothers,* 425 Pa. 1, 229 A. 2d 457 (1967), an employer had adopted a pension plan which provided that there would be vesting of interests in the pension fund only for employees of 10 or more years service who had not had a layoff of more than 12 months. The employer sold out the business and the pension plan was dissolved. An action was brought by employees with less than 10 years' service or layoffs over 12 months for a share of the funds of the terminated pension trust. The lower court granted such an award on the basis that this would be "equitable". The Supreme Court of Pennsylvania reversed and held the suing employees not entitled to any payments, holding that the Pension Agreement "should be enforced in accordance with its terms and courts have no authority to re-draft the agreement . . ."

The Supreme Court of Pennsylvania made it clear that the pension plan was to be carried out strictly in the manner provided in the plan and not otherwise. The importance of this rule of Pennsylvania trust law was emphasized as consonant with the requirements of the Federal Internal Revenue Code of 1954. The Court stated (425 Pa. at 12):

"We agree with appellants that the Chancellor redesigned the Pension Plan to include appellees, basing his conclusion on his theory that the plan was an inducement given by Walker Brothers to enable it to stabilize its work force during periods of slack employment, and its attempt to achieve stable labor relations. We find, therefore, that the Chancellor erred in disregarding the eligibility requirements set up under the provisions of the Pension Plan, by ignoring the provisions that a layoff period in excess of 12 months broke the continuous service required under the terms of the Pension Plan. See Shore v. Bell Tel. Co. of Pa., 389 Pa. 445, 133 A. 2d 157 (1957). The Chancellor does not have the authority to rewrite or amend a plan or make changes, in accordance with his own ideas, as to what is fair and equitable. Neither Walker Brothers, nor IBEW, had anything to gain from the manner in which the fund was distributed upon dissolution.

"The Agreement, in order to meet sound actuarial standards, and, of necessity, designed to meet the exacting standards established by the Internal Revenue Service, must necessarily take into consideration many factors such as normal or expected retirement age; the amount of retirement benefits; questions of termination of service with forfeiture or vesting of rights; the amount of employer's contributions; and the eventual determination of a formula made to provide for things such as normal retirement, deferred retirement, early retirement, and disability retirement, as well as the amount of credit to be allowed for both past and future service. See Bernstein 'The Future of Private Pensions' (1965)."

In *Garner v. Girard Trust Bank,* above, 442 Pa. 166, 275 A. 2d 359 (1971), the Supreme Court of Pennsylvania followed its decision in *Reilly v. Walker Brothers,* above, and held that a court could not liberalize the payout provisions of a profit-sharing plan to pay a former employee a share of the funds where the clear wording of the plan did not provide for such payment. In both cases the Supreme Court of Pennsylvania stated that a "chancellor does not

have the authority to rewrite or amend a plan or make changes, in accordance with his own ideas as to what is fair and equitable" (425 Pa. 1, at 12; 442 Pa. 166, at 169, 275 A. 2d 359, at 361).

While the Justices of the Supreme Court of the United States "ordinarily accept the determination of local law by the Court of Appeals", 337 U. S. 530, 534, 69 S. Ct. 1233, 1235 (1949), the Supreme Court will not accept Court of Appeals determinations of state law contrary to that law as set forth in the decisions of the state's highest court "where the matter decided there is determinative of federal . . . tax consequences." *Commissioner v. Estate of Bosch,* 387 U. S. 459, 462, 464-465, 87 S. Ct. 1776, 1781, 1782-1783 (1967).

We respectfully submit that the court below has thwarted petitioners' right of recovery of overpayment of taxes by disregarding the rules of Pennsylvania trust law determinative of petitioners' right to recover overpayments of taxes under the Internal Revenue Code of 1954.

From the foregoing it is respectfully submitted that the Court of Appeals for the Third Circuit has denied petitioners their rights of recovery of taxes improperly collected from them under the Internal Revenue Code of 1954 by deciding the important state trust law question on which recovery depends contrary to the applicable state law. Pennsylvania trust law unequivocally requires repayment by the beneficiary to the trust of moneys received from the trust in a manner or at a time or in an amount not sanctioned by the trust. Taxpayers did only what they could have been compelled to do, when they restored the moneys which they had received but to which they were not entitled. Under the doctrine of *North American Oil Consolidated v. Burnet,* 286 U. S. 417, 424, 52 S. Ct. 613, 615

(1932), embodied in Section 1341 (a) of the Internal Revenue Code of 1954, taxpayers were entitled to deduct the repayments from their gross incomes for 1960 and are entitled to the refunds sought. By deciding the Pennsylvania trust law incorrectly the court below has denied petitioners their rights to recover the $382,325 they paid in income tax on nonexistent, imaginary income.

Furthermore, the trust law of Pennsylvania is sound law, reflecting in large measure what is considered good law throughout the country. The American Law Institute has demonstrated this in reporting Pennsylvania courts' reliance on the ALI Restatements.

Pennsylvania courts have adopted or relied upon the Restatement of the Law of the American Law Institute for clear statements of the law. Pennsylvania is one of only three states that have referred to the Restatements for guidance in all fields of the Restatements. In the ALI paper book of publications dated October 1, 1970, on page three is a table of frequency of citation of the Restatement by the courts of the several states. Pennsylvania is third in total citations and has cited the Restatement of Trusts more often than any other state. It is, therefore, appropriate to refer to the duty of a beneficiary to restore improper payments, set forth in the Restatement of the Law of Trusts, 2d, Chapter 7, Topic 9, Sections 250 to 257, especially Section 255. Comment c of Section 255 states:

> "c. *Personal liability of beneficiary.* Where the trustee has made such loans or advances* out of the trust estate to a beneficiary, the beneficiary is personally liable for the amount lent or advanced if the interest of the beneficiary is insufficient to repay the amount, unless it was otherwise agreed."

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* "that is a payment to the beneficiary before the time when by the terms of the trust the payment should be made": Section 255, Comment b.

The amounts received from the pension trusts by the taxpayers were not just income but the very principal of the trust from which their benefits after retirement were to be paid. After the payments nothing remained. To carry out the terms of the trusts, that money had to be restored to the trusts and held until properly payable and then only in the limited amounts set forth in the trust instruments.

2. The Court of Appeals for the Third Circuit has rendered a decision in conflict with the decision of a district court in the Eighth Circuit, decided at almost the same time as the Third Circuit decision, now on appeal by the Government.

The District Court of Minnesota denied the Internal Revenue Service the right to levy estate tax on benefits that an elderly majority stockholder might have tried to, but did not, insist that trustees of an employee pension trust turn over to him during his lifetime. *First Trust Company of St. Paul v. U. S.*, 321 F. Supp. 1025 (U. S. D. C. Minn. Nov. 18, 1970). There now is an apparent conflict in decisions between the Third and Eighth Circuits as to treating as income or assets for Federal Tax purposes inchoate pensions where a salaried employee who is a participant in an employee pension plan reaches normal retirement age but does not retire and is not entitled to have the pension money turned over to him under the terms of the pension trust.

In the words of the opinion in that case at page 1028:

> "The record is clear that no one who had reached the age of 65 and who continued his employment with the company was permitted to withdraw his pension fund." * * *
>
> "Moreover, if Mr. Warren had insisted on forcing the Administrative Committee to disobey its rules and

> pay his equity in the pension plan when he reached 65 and continued to work for the company, the Internal Revenue Service no doubt would have revoked its approval of the plan in that under those circumstances it would be conducted in violation of Section 401(a), Title 26, U. S. C. A., which provides that the plan shall be a qualified trust 'if the contribution or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees or highly compensated employees' ".

Although the trial judge would not hear it (R. 753-756) the fact is that the pension plans here involved were approved as "Qualified Pension Plans" by the Commissioner of Internal Revenue under Section 165 (a) of the Internal Revenue Code of 1939, now Section 401 (a) of the Internal Revenue Code of 1954, on December 6, 1944 (R. 692), December 12, 1944 (R. 694), December 19, 1944 (R. 695), and December 22, 1944 (R. 697), allowing under Section 501 (a) of the Code the resulting tax deductions, exemption from income tax, deferral of recognition of contributions in the participant's income, etc. as respects all Qualified Pension Plans.

It is provided by Section 503 (a) (1) (B) of the Code that an organization described in Section 401 (a) shall not be exempt from taxation under Section 501 (a) if it has engaged in a prohibited transaction after March 1, 1954.

Section 503 (b) (6) of the Code provides that the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this Section engages which results in a substantial diversion of its income or corpus to the creator of such organization (if a Trust); a person who had made a substantial contribution to such organization; a member of the family of an indi-

vidual who is the creator of such Trust or who has made a substantial contribution to such organization, etc.

Obligation to pay sufficient to entitle Plaintiffs to relief under Section 1341 existed at the time of repayment in 1960 because of the jeopardy of disqualification in which the acts of Plaintiffs in 1954-58 had placed the Pension Trusts.

Although the point was not adverted to by the Trial Court in its opinion after the hearing (R. 663-681), when Government counsel and the Trial Court were *vis-a-vis* at the argument on Plaintiff's Motions for the Taking of Additional Testimony, the Court (now having the hindsight knowledge that in 1965 or 1966 the Internal Revenue Service had actually disqualified the Pension Trusts) brought forth the question, directing his own attention and that of counsel to the specific situation in 1960 when the repayments were made.

Additional testimony we may not need. It may be legally immaterial (however important it may be psychologically and by way of corroboration) that in 1965 or 1966 in dealing with 1963 taxes the I. R. S. denied qualification to the new profit sharing plans set up January 1, 1963 which were amendments to the old Pension Plans, on the ground that they were tainted with the disqualification of the old Pension Trusts resulting from the prohibited transactions of illegal withdrawals in the prior years of 1954-58 (R. 698-706).

But, irrespective of that and without regard to what the I. R. S. actually did in subsequent years, there is no escape from the fact, which the trial judge clearly pointed out in his colloquy with Government counsel, that when the first withdrawal occurred in 1954 the pension trust or plan there involved was immediately placed in jeopardy of disqualifi-

cation under Section 503 of the Code and thereby (R. 754) the Trusts stood in immediate danger of losing their tax exempt status; the corporate employers stood in immediate danger of never being able to obtain a deduction for contributions to the trusts.

What is worse, the participants in the Trusts stood in immediate danger of being taxable on the contributions; there was an immediate danger of capital gains provisions becoming inapplicable and distributions from the Trust, as non-qualified, becoming taxable as ordinary income in the year paid or made available.

There was also immediate danger of the Estate Tax Exclusion of Section 2039 (c) being lost and the Gift Tax Exemption of Section 2517 being lost (R. 718). (26 N. Y. U. Institute on Federal Taxation 1073.)

The district court properly held (R. 674) that as to repayment the "compulsion need not be the judgment of a court". In accord are Revenue Ruling 58-456 ("For example if repayment is made pursuant to a demand by the F. H. A. under circumstances entitling such Administration to enforce the demand by legal action in the absence of compliance such repayment would be considered as involuntary" App. 57); *Joseph S. Pike*, 44 T. C. 787 Acq. 1968-2 C. B. 2 (lawyer repaid to protect his business reputation); *William L. Mitchell*, 52 T. C. 170 (1969) (General Motors executive who had realized "inside profits" under S. E. C. rules repaid); G. C. M. 16730 (XV-1 Cum. Bul. 179) (1936) (App. 51), cited with approval by the Supreme Court of the United States in U. S. v. Skelly Oil Co., 394 U. S. 678, 683, 89 S. Ct. 1379, 1383 (1969).

We respectfully submit that it was error for the trial judge to close his eyes to what he had so clearly seen and

recognized at argument, to-wit, that the jeopardy of disqualification under the Internal Revenue Code in which the pension trusts were placed by the acts of the taxpayers in 1954-1958 remained like the sword of Damocles hanging over the heads of the trusts, the settlor corporations and the beneficiaries in 1960 when the repayments were made. Under Pennsylvania trust law, as stated by the Supreme Court of Pennsylvania consistently whenever such questions have arisen, the settlor corporations or the trustees or other beneficiaries, who were or might be injured by I. R. S. disqualifications and were already injured by being placed in jeopardy thereof could have come into court and forced the restitution or restoration necessary to avert any adverse action by the I. R. S. on the basis of the prohibited transactions in which the Taxpayers had indulged themselves.

The jeopardy of disqualification forced the Taxpayers to eliminate the grounds which ultimately triggered the sanctions applicable to prohibited transactions. The Internal Revenue Service has ruled (Revenue Ruling 67-9; App. 66) that an organization which has been denied exemption under Section 501 (c) (3) by reason of having engaged in a prohibited transaction may not reestablish exemption until "the grounds for the original denial of exemption shall have been removed." Short of the restoration of the withdrawals there was no way of removing the grounds for denial of the exempt status.

Regardless of anything else in the case, this element of jeopardy of disqualification existing in 1960 when the repayments were made provided the damage to other beneficiaries and the settlor corporations necessary to give them rights of compulsion against the taxpayers in court.

Taxpayers' position *re* the peril of disqualification of the Trusts has been clearly recognized by the Internal Revenue Service in Revenue Ruling 70-315 (App. 71). That Ruling deals with a fact situation involving failure to make distributions in accordance with the terms of a qualified pension plan. In the analogous fact situation of this case, the district court (R. 667) also found that the distributions were made "in violation" of the terms of the trust. As to the consequences of the trust violations, the Internal Revenue Service there stated:

> "However, any failure to make distribution in accordance with the terms of the plan will be considered in determining whether the plan continues in a qualified status and whether distributions thereunder continue to be deductible under section 404 (a) (1) of the Code."

In *Community Services, Inc. v. U. S.*, 422 F. 2d 1353, 1359 (Ct. Cl. 1970), where the Government contended that an employer's payments to an employees' profit-sharing plan should not be allowed as deductions from gross receipts in determining taxable income, the Court upheld the employer's position and awarded it the tax refunds sought. What the Court stated in that case, 422 F. 2d at 1359, concerning the particular profit-sharing plan there involved could generally be stated respecting the employee pension plans involved here:

> "We will readily admit that the profit-sharing plan as it was drafted in 1962 and 1963 is not a model of perfection, and we do not begin to recommend it as such. Instead, we take note of the fact that the plan apparently was very hastily and very poorly put together. However, despite the careless drafting, we do not feel that the plan was such that it should not qualify as a profit-sharing plan under section 401 (a). We are convinced that plaintiff acted in complete good faith and with the best intentions of setting up a valid

> retirement plan for its employees. This feeling has since been substantiated by the subsequent conduct of plaintiff and its continuation of the plan. A decision for defendant at this time, withholding the claimed deductions, would only cause harm to the beneficiaries of the plan in that the amount of plaintiff's contributions would be proportionately less."

Please note that in that case, after IRS questioned provisions of the plan, the taxpayer amended the plan and IRS approved the amended plan. 422 F. 2d 1359, note 6. The Court pointed out the harm that would result to the employees if the payments into the plan were not allowed to be treated as expenses or the plan were not considered qualified. 422 F. 2d 1359, note 7. In the present case the taxpayers in 1960, at great expense and effort to themselves, restored the pension trusts to the status in which they had been qualified (R. 668; R. 692-696), but seven years later the IRS disqualified the plans for acts that had long since been corrected (R. 698-700). The court below pointed out that the amounts restored were not the full amounts withdrawn (App. A, 2, note 2). These differences represented moneys of their own that the taxpayers had deposited in the trusts (See R. 275).

If IRS were allowed to capriciously disqualify pension or profit-sharing plans whenever it chose, neither employees nor their employers could any longer have faith in the plans that have become a vital part of modern businesses to encourage the best possible services by employees in return for assurance that when they are no longer able to perform to satisfactory standards, they will be able to retire in reasonable comfort as their duties are assumed by younger employees of the desired capabilities.

It is a matter of common knowledge that there has been a persistent growth of pension plans—public and private—

for many years. Dan M. McGill, *Fundamentals of Private Pensions,* ch. 1, Underlying Forces, pp. 1-28 (U. of Pa. Wharton School of Finance and Commerce, Pension Research Council, 1955, 1960), where it is stated:

> "The private pension movement is rooted in one of the most significant economic, social and political developments of the twentieth century—the progressive aging of the population."

It is pointed out that in 1900 only 4 percent of the American population was 65 or over, that by 1955 the numbers had risen to 8.5 percent, and that by 2000 there will be a 65 or older portion of the population of between 11 and 13 percent. The steady increase in numbers of pension plans and numbers of persons covered is emphasized.

The four pension plans involved here (R, Vol. II, 985-1025) were funded with individual retirement annuity policies. This was a common method of funding pension plans in 1936 and 1941, when these four plans were instituted. At that time there were few pension plans and limited methods of satisfactory funding. This is explained in David W. Gregg, *Life and Health Insurance Handbook* (1959), Chapter 25, pp. 283-284, as follows:

> "The individual policy plan is particularly suitable for the small group of about 50 or fewer initial participants. It can, of course, be used in plans of any size. It is an interesting and modern application of the insurance idea to a current economic problem.
>
> . . .
>
> "This method of funding pension plans became most popular and was most generally used in the early 1940's. . . .

> "Changes since the middle 1940's in certain group media and the creation of new types of group coverage for pension purposes, such as group permanent and deposit administration, have moved the individual policy plan into a smaller area of acceptability. . . . Consulting actuaries have become more willing to recommend self-administration . . .
>
> "Nevertheless, the over-all growth of individual policy pension plans has been great. At the end of 1940 there were 440 such plans in existence in this country. By the end of 1958 that number had increased to 16,440. About one third of all employee trust plans qualified with the Internal Revenue Service use individual policies as the sole or partial funding medium."

Studies published by the United States Department of Labor in its Monthly Labor Review have dramatically shown not only the increases in numbers of persons covered by pension plans but the increases in amounts of benefits during the past 20 to 30 years.

In *"Fringe Benefits For Nonfarm Workers"*, 91 U. S. Dept. Labor Monthly Labor Review 40, 46 (June 1968), Table 4, it was pointed out that in its study of fringe benefits among industrial workers, the Department had found that in 1967, 73 percent of plant workers and 82 percent of office workers were covered by retirement pension plans. In 1960, the percentages had risen, respectively, to 66% and 76%.

"Private Pension Plans, 1960-1969—An Overview", by Harry E. Davis and Arnold Strasser of the U. S. Bureau of Labor Statistics (93 U. S. Dept. Labor Monthly Labor Review 45-56, esp. 45-46, July 1970) dramatically shows the increase in numbers of pension plans and numbers of employees covered during the 1960's and states that these growths are less than half the expansion during the 1950's.

3. The decision of the court below is contrary to basic principles of tax accounting long established and recognized by decisions of this court.

These accounting principles go back to the fundamental concept of the annual accounting period illustrated in *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 365-366, 51 S. Ct. 150, 152 (1931). They were developed further in *North American Oil Consolidated v. Burnet*, 286 U. S. 417, 424, 52 S. Ct. 613, 615 (1932), where the court held that a taxpayer who received money "under a claim of right and without restriction as to its disposition . . . has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." If payment is required in a later year, the taxpayer may take a deduction in the year of repayment. *U. S. v. Skelly Oil Co.*, 394 U. S. 678, 683-684, 89 S. Ct. 1379, 1382-1383 (1969). In *U. S. v. Skelly Oil Co.*, 394 U. S. 678, above, this court pointed out that the deduction allowed the taxpayer should not be interpreted to allow a taxpayer the practical equivalent of double deduction for income tax purposes. The present case presents the converse situation. Here the government has contended, and the courts below have interpreted the Internal Revenue Code, to allow no deduction, although the taxpayer was required by law to restore the funds and the government has insisted on collecting income tax as though no restoration had been made.

In its Petition for a Writ of Certiorari in *U. S. v. Skelly Oil Co.*, 394 U. S. 678 above, at page 9 of the petition, the government pointed out that it has long been established, for example, that where an accrual has been made and deducted for wages, the amount must be restored to income

when it is later determined that the wages are unclaimed. *Chicago, R. I. & P. Railway Co. v. Commissioner,* 47 F. 2d 990 (C. A. 7), certiorari denied 284 U. S. 618; *Charleston and Western Carolina Railway Co. v. Burnet,* 50 F. 2d 342 (C. A. D. C.). The present case is the converse of the same proposition. Where money has been received to which the taxpayer does not have a right, he must restore it; and when what was thought to be income shows itself to have been an error of inclusion it may be deducted from current income, as was the case in *North American Oil Consolidated v. Burnet,* 386 U. S. 417, above, as was claimed in this case. There is also an alternative to use the redetermination as a basis for restating the tax in the year in which the money was treated as income, provided in Section 1341 of the Internal Revenue Code of 1954, as amended, 26 U. S. C. 1341. In *U. S. v. Skelly Oil Co.,* 394 U. S. 678, Mr. Justice Marshall made it clear that money received under a claim of right and restored when the taxpayer finds he did not have a right to the money, is entitled to be deducted from income by the taxpayer on the return for the year of repayment or by amending the original return.

The establishment and maintaining of pension plans are important phases of operating businesses. The costs of the plans are part of the costs of doing business. These costs must be subtracted from gross revenue before taxable income can be determined. As the Court of Claims pointed out in *Community Services, Inc. v. U. S.,* 422 F. 2d 1353, above, the disqualification of pension plans for past errors that have been corrected "would only cause harm to the beneficiary of the plan." 422 F. 2d at 1359.

To deny the taxpayers the deduction claimed here is contrary to all principles of income taxation, because it is

taxing money mistakenly received even though the mistake has been corrected and the taxpayers did not have the benefit of the monies received but restored the same because required to make restoration. It in effect taxes money that the taxpayer neither has nor has any entitlement to receive. It establishes a penalty unable to be paid from the money that caused the penalty. It discourages and tends to prevent the restoration of funds mistakenly received to their source. It tends to undermine the whole system of pension plans under which long-service employees expect to receive their reasonable retirement benefits promised them by their employers and on the strength of which they dedicated their working lives to their employers.

4. The court below, by denying the Petitioners recovery of taxes paid on non-existent income, has decided a Federal question in a way in conflict with applicable decisions of the Supreme Court of the United States.

The Supreme Court of the United States had established general principles of fairness to Government and taxpayers alike. In *Stone v. White,* 301 U. S. 532, 535, 57 S. Ct. 851 (1937), this Court called attention to the principles that "statutes authorizing tax refunds and suits for their recovery are predicated upon the same equitable principles that underlie an action in assumpsit for money had and received."

In *United States v. Skelly Oil Co.,* 394 U. S. 678, 89 S. Ct. 1379 (1969), this Court in effect applied such principles to a recovery of taxes paid on money thought to be income and found later not to have been. The recovery allowed was limited to the net amount of tax paid; not the gross amount without regard to the depletion allowance that had been taken by the taxpayer.

In the present case the taxpayers necessarily restored to employee pension trusts amounts not payable to the taxpayers. The court below disallowed return of the income tax paid on those amounts, even though the taxpayers did not actually have those amounts any longer and were not entitled to have them.

It is respectfully submitted that this Court has never authorized taxation of imaginary income and should reverse such taxation here.

Conclusion

The Petition for Writs of Certiorari should be granted for the reasons set forth above.

Respectfully submitted,

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June, 1971.

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 18,852

JOHN F. KAPPEL and EDNA I. KAPPEL,
Appellants,

v

UNITED STATES OF AMERICA.

(D. C. Civil Action No. 64-1091)

No. 18,853

Estate of WILLIAM J. KAPPEL, Deceased, by SARAH M. KAPPEL and WILLIAM D. KAPPEL, Executors, and SARAH M. KAPPEL,
Appellants,

v

UNITED STATES OF AMERICA.

(D. C. Civil Action No. 64-1092)

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Argued December 11, 1970

Before: ALDISERT, ADAMS and ROSENN, *Circuit Judges.*

Opinion of the Court

(Filed February 1, 1971)

ADAMS, *Circuit Judge*

The taxpayers in this case improperly received distributions from four employees' pension trusts and upon threat of assessment by the Internal Revenue Service ("the Service") paid an income tax on the distributions. Proceeding to restore the distributions to the respective pension trusts, the taxpayers then deducted on their 1961 return, pursuant to § 1341 of the Internal Revenue Code of 1954 ("the Code"),[1] the amount of the income tax paid pursuant to the threatened assessment. The Internal Revenue Service disallowed the deduction, the taxpayers paid the contested tax, and then brought this suit for a refund.

The issue raised on this appeal is whether the appellants are entitled to a refund of the taxes paid, and this in turn depends primarily on whether they had a "legal obligation" to repay the amounts improperly received from the pension trusts so as to qualify for the deduction provided by § 1341 of the Code.[2]

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[1] 26 U. S. C. A. § 1341. "Computation of tax where taxpayer restores substantial amount held under claim of right. (a) General rule. —If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item;

* * *

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deductions, minus

(B) the decrease in tax under this chapter . . . for the prior taxable year . . . which would result solely from the exclusion of such item . . . from gross income for such prior taxable year. . . ."

[2] We note that while $182,838.12 was received by John F. Kappel and $442,122.60 was received by William J. Kappel, only $160,658.49 and $400,176.63 was returned respectively.

Although the taxpayers have presented to this Court alternative theories for deductions under §§ 162 and 165 (c)(2)[3] of the Code, the District Court made no findings on these issues,[4] nor were these matters raised in the complaints filed in the District Court, in taxpayers' "narrative statement" to that Court, or in taxpayer's motions under Fed. R. Civ. P. 52(b) and 59(a) to amend findings of fact, to alter or amend judgment or for a new trial. We therefore decline to consider these claims since they are not properly raised by this appeal. *See* Hanley v. Chrysler Motors Corp., 433 F. 2d 708, 711 (10th Cir. 1970).[5]

Taxpayers John and William Kappel were officers, directors, and principal stockholders in four corporations which maintained separate employees' pension plans instituted in the 1930's and 1940's.[6]

The plans were recommended to taxpayers by Jules Polachek, a Pittsburgh life insurance underwriter who held himself out as, and was generally reputed to be, an expert in the field of corporate pension plans. The pension

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[3] 26 U. S. C. A. § 162: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ."

26 U S. C. A. § 165(c)(2): "There shall be allowed as a deduction . . . losses incurred in any transaction entered into for profit . . ."

[4] We do not regard the District Court's statement that there were "no business considerations or economic benefits in this case sufficient to support any deduction under any other section of the Code" than § 1341 as laying a proper foundation for raising the specific application of §§ 162 and 165 on this appeal, because the taxpayers never squarely presented these particular provisions to the Court.

[5] This case does not appear to present "exceptional" circumstances justifying a departure from the rule disfavoring consideration of new legal theories on an appeal. For cases justifying a determination of new issues, see *e.g.* Green v. Brown, 398 F. 2d 1006 (2d Cir. 1968); Wratchford v. S. J. Groves & Sons Co., 405 F. 2d 1061 (4th Cir. 1969). Our view of this matter is bolstered by the fact that different evidence might be adduced in the District Court by both sides to support or oppose these new theories.

[6] Their wives are parties here only because they joined in the returns filed for the calendar year 1960, and no further reference will be made to them. Also, because taxpayer William J. Kappel died after the trial of the case, his estate was substituted for him as plaintiff.

plans in this case were governed by separate groups of trustees chosen by the board of directors of each corporation. Taxpayers and their relatives constituted a majority of the trustees for each trust. Each trust was funded by one of the four settlor corporations, and the trustees contracted for separate annuity policies on each participating employee, including taxpayers, through several life insurance companies. The ownership of each policy was vested in the trustees governing the particular trust of the corporation employing each beneficiary.

In 1954, when both taxpayers were over 65 years of age but still active in the corporations, Polachek suggested a method which would remove the annuities in the pension trust from the estates of the taxpayers; the Kappels were to continue their employment, but to agree to an immediate distribution of the proceeds of the annuity policies held by the pension trusts for the taxpayers' benefit; these proceeds would then be reinvested in deferred annuities, with members of taxpayers' families named as beneficiaries. Polachek told taxpayers they would incur no federal income, gift, or estate tax liability for these transactions.

Despite contrary provisions in the pension trusts,[7] the taxpayers relied on Polachek's advice, and the proceeds were removed and reinvested in 1954, 1955, 1957 and 1958. In each instance, application was made on behalf of the trustees to the various life insurance companies for the proceeds that were being held to insure the lives of the taxpayers to be paid in a lump sum, and these amounts were then forwarded to Polachek. The applications to the insurance companies were signed either by

[7] Each pension trust provided that pension benefits could not be paid to a beneficiary in one lump sum; no beneficiary had any power of anticipation of the payments provided in the annuity policy; no sale, assignment, transfer, anticipation, commutation, or alienation could be made by a beneficiary.

taxpayer John T. Kappel, or by William D. Kappel (son of William J. Kappel, the other taxpayer). The District Court found there was no consent, joinder, or formal action by all or a majority of the trustees of any pension fund in the application for payment of the annuity proceeds.

Late in 1959, the Service informed the Kappels of its intention to assess deficiencies regarding their individual income taxes for each of the years in which annuity proceeds had been received but not reported as income. In response to this information, the Kappels retained expert legal and accounting representatives. These counsel advised the Kappels that the pension benefits had been paid in violation of provisions of the pension trust agreements, and that the taxpayers were obliged to refund the payments to the pension trusts. After extended demands and negotiations, legal counsel secured refunds from the insurance companies of the premiums paid for the deferred annuities, and the taxpayers restored such funds to the pension trusts in 1960.

No legal proceedings were instituted to require such repayments, but the question on this appeal is whether there existed a legal obligation on the part of the Kappels to repay to the trusts the monies improperly received. In 1961, the Kappels claimed a deduction on their 1960 tax returns based on § 1341 of the Code for taxes paid upon the funds received from the pension trusts in 1954, 1955, 1957 and 1958. The Service disallowed the claimed deductions, the Kappels paid the taxes due, and in 1964 filed in the District Court their complaints demanding a refund of such taxes. Honorable Gerald J. Weber, United States District Judge for the Western District of Pennsylvania, ordered the two complaints consolidated for trial.

After a trial lasting five days, Judge Weber found in an opinion reported at 281 F. Supp. 426 (W. D. Pa. 1968) that the taxpayers had no legal obligation to return the funds that had been withdrawn from the trusts, and accordingly, rendered a decision for the United States. Taxpayers then moved to take additional testimony to show that in 1967 the Service found the original pension trusts all to have been disqualified under § 503(c)(6) of the Code as qualified pension plans within the meaning of § 401 of the Code as of the years in which improper withdrawals were made. See also § 503(a)(2). The trial judge denied the motion for the taking of further testimony because "there was no such threat existing in 1960, either by other beneficiaries who could allege impairment of the trust *res*, or by those affected by the loss of tax benefits first raised . . ." several years later.

The Court then entered judgments in favor of the Government, and the taxpayers appealed.

In order to prevail, the taxpayers rely on the claim of right doctrine codified in § 1341. This theory originated in North American Oil v. Burnet, 286 U. S. 417, 424 (1932), in part as a criterion for determining what constituted "gross income" within the meaning of the predecessor of § 61 of the Code, but primarily as an application of the annual accounting principle consistently mandated by Congress to be an integral part of the income tax system. See Burnet v. Sanford & Brooks Co., 282 U. S. 359 (1931). As the Supreme Court has recently stated in United States v. Skelly Oil Co., 394 U. S. 678, 681-2 (1969), "[s]ection 1314 of the 1954 Code was enacted to alleviate some of the inequities which Congress felt existed in this area. See H. R. Rep. No. 1337, 83d Cong., 2d Sess., 86-87 (1954) . . . Nevertheless it is clear that Congress did not intend

to tamper with the underlying claim-of-right doctrine." An example of an inequity troubling Congress was the fact that prior to the enactment of § 1341 a taxpayer, because of a change in his tax bracket, might not receive a tax benefit in the year of repayment of the item equivalent to the tax detriment suffered in the year when the item was taken into income. See Healy v. Commissioner, 345 U. S. 278 (1953).

The requirement that a legal obligation exist to restore funds before a deduction is allowable under the claim of right doctrine is derived from the language of § 1341(a)(2) of the Code: "a deduction is allowable . . . because it was established . . . that the taxpayer did not have an unrestricted right to such item . . ." *See e.g.*, Crellin's Estate v. Commissioner, 203 F. 2d 812 (9th Cir. 1953); Joseph P. Pike v. Commissioner, 44 T. C. 787 (1965). In pursuing the rationale for this requirement, it is necessary to distinguish between cases where one never in fact had a right to an item of income and may not legally continue to use it as he pleases, and situations where regardless of the doubtfulness of his right to the item, he may nevertheless continue to exercise dominion over the item.

Taxpayers do not dispute the above principle of law, but rather argue that either the remaining trustees or the beneficiaries of other annuities under the trusts could legally have compelled repayment of the amounts improperly withdrawn. The difficulty with this argument is that the trial judge found (1) taxpayers, as beneficiaries, consented to any breach of the terms of the trust agreement committed by the trustees; (2) taxpayers, as principal officers and stockholders, also consented to such breach on behalf of the settlor corporations; and (3) in any event no

impairment or injury to the interest of any other beneficiary in the trusts resulted from the payments because each beneficiary was covered by a separate annuity contract.

The taxpayers recognize that the third finding is particularly damaging to their case and argue that it is clearly erroneous within the meaning of Fed. R. Civ. P. 52(a). This contention is based on the premise that the withdrawal of funds by the Kappels placed the tax exempt status of the pension trusts in such jeopardy that the other beneficiaries could have persuaded a court of equity to require the taxpayers to replace the funds in an attempt to save the preferred tax status of the pension trusts.

At trial, however, the taxpayers presented no evidence that this theory motivated them to refund the annuity proceeds, but rather argued they could have been compelled to return the money solely because it had been removed in a manner contrary to the trust agreements. Only after Judge Weber filed his opinion containing findings of fact and conclusions of law adverse to the taxpayers on the theory pursued at trial was this new causative theory presented in the form of motions under Fed. R. Civ. P. 52 and 59.

Because we cannot find Judge Weber's findings of fact to be clearly erroneous on the basis of the evidence presented to him, we must decide whether he abused his discretion in refusing to hear further evidence, or erred as a matter of law in refusing to alter or amended the judgment.

Preliminarily, we note that the taxpayers have the burden of proving their eligibility for a claimed deduction, in order to recover taxes alleged to have been erroneously collected. United States v. Anderson, 269 U. S. 422

(1926). The taxpayers did not meet this burden with respect to their original theory of the case, but they have suggested in their briefs that no new evidence need be adduced to support their new theory. We will, therefore, as Judge Weber appears to have done, examine directly the merits of taxpayers' argument in this regard.

We agree that the loss by a pension trust of its income tax exemption under § 503 of the Code carries very serious and adverse consequences to the employer and employees. Nonetheless, § 1.503(d)-1(a) of the Income Tax Regulations provides that an organization denied exempt status because it has engaged in a prohibited transaction, may regain its exempt status by filing a new claim of exemption, and a "a written declaration . . . by a principal officer . . . that the organization will not knowingly again engage in a prohibited transaction." Section 1.503(d)-1(b) of the Regulation then recites that the Commissioner of Internal Revenue shall notify the organization whether or not he is satisfied with its statement. Assuming, without deciding, that some type of action (at least for damages) could be maintained against taxpayers by the other beneficiaries for loss of the tax exempt status of the pension trusts, the question is whether a Pennsylvania state court would order the funds, themselves, to be restored because their removal placed the exempt status in jeopardy.[8]

[8] Because the District Court found the situs of each pension trust to be Pennsylvania, and the trust instruments are silent as to the place of administration, the law of Pennsylvania controls the administration of the trusts. See *e.g.*, Haberland v. Haberland, 305 F. 2d 345 (3rd Cir. 1962). While the Government has argued that only actions which might be brought against beneficiaries are relevant, the taxpayers at oral argument have pointed to possible actions against trustees as equally important. For purposes of the claim of right doctrine we believe the Government to be correct. The withdrawals here were required to be taken into income by the Kappels not because they, as trustees, caused them, but because they, as beneficiaries, received them. The relevant obligation to repay, therefore, must arise from the taxpayer's role as beneficiary rather than as a trustee. Otherwise, the availability of the claim of right relief provided by § 1341 of the Code would turn on what is merely the fortuity

(Footnote continued on following page)

In support of their claim, taxpayers cite, somewhat anachronistically, Revenue Ruling 67-9, 1967-1 Cum. Bull. 143. That Ruling purports to explain § 1.503(d)-1 of the Regulations, stating "these regulations presuppose that, in the case of an organization denied exemption by reason of its having engaged in a prohibited transaction, the grounds for the original denial of exemption shall have been removed before an exemption may be reinstated for future years." In substance, the Ruling required that a loan made without adequate security either be repaid or adequate security posted, for otherwise the violation would be "continuing." The violation here, however, was not "continuing" in the sense that word is used in the Ruling, for the continuation of the Kappels' withdrawals did not imperil the integrity of the trusts. Each beneficiary's pension was separately funded; no funds of anyone but the Kappels were withdrawn. The very fact that improper withdrawals from the trusts had occurred was the ground for disqualification (see *e.g.*, Rev. Rul. 55-297, 1955-1 Cum. Bull. 393). But whether the Service would require restoration of the funds, rather than, for example a change in the composition of the board of trustees, as a condition for regranting the exemption is not clear even today. Compare Rev. Rul. 69-233, 1969-1 Cum. Bull. 156; Rev. Rul. 70-315, 1970 Int. Rev. Bull. No. 25 at 8.

(Footnote continued from preceding page)

of holding dual positions. If the Kappels, as trustees, were compelled to repay the funds they improperly authorized to be withdrawn, relief must be sought in other sections of the Code. Without intimating any view in regard to this case, it is conceivable, for example, that a business expense deduction might be allowable to a trustee under § 162 of the Code for damages arising from a breach of his fiduciary duties. Since we believe Judge Weber to have been correct in determining that no discernible harm had yet befallen the other beneficiaries, at the time the money was repaid, we need not resolve whether the principles expressed in Restatement of Trusts 2d § 265 rather than § 256 would control any appropriate remedy the other beneficiaries might otherwise have.

Thus, we believe Judge Weber to have been correct in holding that the taxpayers did not demonstrate the existence in 1960—when the funds were repaid—of a valid equitable claim by the other beneficiaries or trustees which would have required the Kappels to return the funds to the trusts. This being so, there is no compliance here with the requirements of the claim of right doctrine.

Accordingly, the judgment of the District Court will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

Judgment

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 18,852

JOHN F. KAPPEL and EDNA I. KAPPEL,
Appellants,

vs

UNITED STATES OF AMERICA.

(D. C. Civil Action No. 64-1091.)

No. 18,853

Estate of WILLIAM J. KAPPEL, Deceased, by Sarah M. Kappel and William D. Kappel, Executors, and Sarah M. Kappel,
Appellants,

vs.

UNITED STATES OF AMERICA.

(D. C. Civil Action No. 64-1092.)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Present: ALDISERT, ADAMS and ROSENN, *Circuit Judges.*

This cause came on to be heard on the record from the United States District Court for the Western District of Pennsylvania and was argued by counsel

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, filed January 19, 1970 be, and the same is hereby affirmed.

ATTEST:

THOMAS F. QUINN,
Clerk.

February 1, 1971.

APPENDIX B

Office of the Clerk
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT
2046 U. S. Courthouse
Ninth & Chestnut Streets
Philadelphia 19107

Telephone
215-597-2995

Thomas F. Quinn
Clerk

March 19, 1971

Re: John F. Kappel, et al., Appellant vs. U. S. A.
No. 18,852/3

Herewith in conformed copy of order entered today.

T. F. QUINN,
Clerk.

cc: To all parties
ags

***Sur* Petition for Rehearing**

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 18,852/3.

JOHN F. KAPPEL and EDNA I. KAPPEL,
Appellants,

v.

UNITED STATES OF AMERICA

Estate of WILLIAM J. KAPPEL, Dec. by SARAH M. KAPPEL and WILLIAM D. KAPPEL,
Appellants,

v.

UNITED STATES OF AMERICA

Present: HASTIE, *Chief Judge,* and FREEDMAN,* SEITZ, VAN DUSEN, ALDISERT, ADAMS, GIBBONS and ROSENN, *Circuit Judges*

The petition for rehearing filed by John F. Kappel and Edna I. Kappel and Estate of William J. Kappel, Deceased, by Sarah M. Kappel and William D. Kappel, and Sarah M. Kappel in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court *in banc*, the petition for rehearing is denied.

BY THE COURT,
ARTHUR N. ADAMS,
Judge.

Dated: March 19, 1971.

* Judge Freedman participated in the vote on this petition for rehearing but died before the filing of this order

APPENDIX C

Opinion

Civil Action No. 64-1091.

Civil Action No. 64-1092.

(Filed March 22, 1968.)

WEBER, *J.*

FINDINGS OF FACT.

1. These two consolidated actions are suits for the recovery of overpayment of individual Federal Income Taxes for the year 1960.

2. Plaintiffs are John F. Kappel and his wife, and William J. Kappel and his wife, each married couple having filed joint United States Income Tax returns for the calendar year 1960, on or before April 15, 1961. The operative facts concern only the husband plaintiffs. References to Plaintiffs hereinafter will refer only to husband plaintiffs.

3. Each of plaintiffs' 1960 income tax returns reported an overpayment of tax beyond the amount due as follows:

John F. Kappel and wife	$120,334.18
William J. Kappell and wife	261,990.87

4. The above-claimed overpayments were based upon a claim under § 1341, Internal Revenue Code of 1954.

5. The Internal Revenue Service refused to acknowledge such overpayments and demanded payments thereof which plaintiffs paid.

6. Plaintiffs' timely claims for refunds were denied by the Internal Revenue Service and the present actions were timely filed.

7. Plaintiffs were officers, directors, principal stockholders and employees in four corporations each of which maintained Employees Pension Plans since 1936 and 1941 in which plaintiffs were participating employees.

8. Plaintiffs were members of the Board of Trustees of each of the Employees Pension Plans. Such trustees were chosen by the Board of Directors of each corporation.

9. In each instance the settlor corporations funded the trusts and the trustees contracted for separate annuity policies on each participating employee, including the plaintiffs, in ten different life insurance companies.

10. Ownership of the annuity policies on all beneficiaries of all pension trusts was vested in the trustees of the particular pension trust of the employing corporation of each beneficiary.

11. Each pension trust contained provisions that:

(a) Pension benefits could not be paid to a beneficiary in one lump sum;

(b) No beneficiary shall have any power of anticipation of the payments provided in the annunity policy;

(c) No sale, assignment, transfer, anticipation, commutation, or alienation may be made by a beneficiary, and all payments must be made to a beneficiary personally, or to a beneficiary designated to receive benefits at his death;

(d) When an employee reaches the age of 65, or on his earlier retirement, the trustees shall arrange to have the benefits of his annuity paid to him in accordance with the options of the policy;

(e) The trustees reserved the right in their discretion to terminate the trust or amend it, except that they could not deprive any employee of any rights to which he became vested under the pension plan.

12. Each plaintiff was over sixty-five years of age at the time of the withdrawals made in 1954-1958, and each plaintiff was still an active employee of the corporations in which he participated under the pension plans.

13. The pension plans were originally proposed to plaintiffs' employer corporations by Jules Polachek, a Pittsburgh life insurance underwriter, who held himself out as and was generally reputed to be an expert in the field of corporate pension plans. The trustees relied upon his advice and assistance at all times. He prepared the Trust Agreements, and provided for the purchase by Trustees of the annuities for each beneficiary from life insurance companies that he represented. Polachek collected corporate and employee contributions, transmitted them to the companies, processed applications and determined questions of coverage.

14. In 1954, Polachek suggested to the two plaintiffs that if they, without retiring from employment, would agree to the distribution of the proceeds of the annuity policies held by the Trustees for their benefit, and the reinvestment of such benefits in deferred annuities naming members of their families as beneficiaries, they would incur no Federal Tax liability for income, gift or estate taxes.

15. Relying on the advice of Polachek, application was made on behalf of the Trustees, signed by John F. Kappel, plaintiff herein, or William D. Kappel (son of William J. Kappel, plaintiff), in their capacity as Trust Secretaries of the various pension trusts, to the various life insurance

companies for the proceeds of the annuities on the lives of the plaintiffs. The applications were processed and forwarded through Jules Polachek.

16. There was no consent, joinder, or formal action by all the Trustees of any Pension Trust involved, or a majority of them, in such application for payment of the proceeds of the annuities.

17. Each of the ten insurance companies paid the proceeds of the annuity policies upon such application. Payment was made by twenty-three separate checks. Eighteen of the checks, made payable to the pension trusts, were endorsed solely by John F. Kappel, plaintiff herein as Trust Secretary. Two of the checks were endorsed solely by William D. Kappel (son of plaintiff William J. Kappel) as Trust Secretary. One of the checks was endorsed by John F. Kappel and William D. Kappel, as Trustees. Two checks, issued by New England Mutual Life Insurance Company were endorsed by several of the Trustees, describing themselves in the endorsement as the Trustees of the two pension trusts involved.

18. The endorsement on all of said checks made them payable directly to Dominion Life Assurance Company or American United Life Insurance Company in accordance with instructions of Jules Polachek, and said checks were delivered to Polacheck who forwarded them to the respective insurance companies and secured the issuance of deferred annuity contracts on the lives of members of the families of Plaintiffs according to the respective shares of each plaintiff in such proceeds. Polachek received commissions from the issuing insurance companies as agent.

19. The above transactions occurred in the years 1954, 1955, 1957 and 1958. No report of receipt of the proceeds of these pension trust annuities was made in either of plain-

tiffs' Federal Income Tax return for the years in which the policies were cancelled and the proceeds used to purchase annuities on the lives of members of plaintiffs' families.

20. Late in 1958 the Internal Revenue Service notified plaintiffs of its intention to assess deficiencies on their income taxes with respect to the years 1954, 1955, 1957 and 1958.

21. Upon the Internal Revenue Service's claim for individual income taxes on the proceeds of the pension policies, plaintiffs engaged legal counsel and accounting representatives who advised plaintiffs that the distribution of pension policy benefits to them were in violation of the provisions of the Pension Trust agreements and that plaintiffs were obliged to refund the payments to the Pension Trusts concerned.

22. Legal counsel for plaintiffs also informed the Trustees of the Pension Plans involved, that the proceeds of the insurance policies paid to plaintiffs had been paid contrary to the terms of the Pension Trust agreements and that the trustees were under a legal duty to require repayment. Upon receipt of such advice, the Trustees authorized legal counsel to take such action as was necessary to secure restoration of the funds to the Pension Trusts.

23. The violations of the Pension Trust Agreements involved in such payments were violations of the prohibition against lump sum payment and violation of the maximum monthly installment payments provision.

24. Plaintiffs, as beneficiaries of the Pension Trusts, consented to any breach of the terms of the Trust Agreement. Settlors also consented by the acts of their principal officers and stockholders.

25. No impairment or injury to the interest of any other beneficiary in the trust *res* resulted from such payment.

26. Thereafter, legal counsel, acting on behalf of the Trustees, by demands, negotiation and threats of litigation, made against Dominion Life Assurance Company and American United Life Insurance Company, secured the cancellation of the annuity contracts on lives of members of plaintiffs' families which had been purchased with the funds received by plaintiffs from the Pension Trusts. The two life insurance companies repaid the funds which they had received from plaintiffs.

27. No legal proceedings were instituted by any beneficiaries against the Trustees or Plaintiffs, and no legal proceedings were instituted by Trustees or any of the Trustees to require adherence to the Trust Agreement provisions, or to surcharge Trustees or to require repayment by Plaintiffs of the funds received by them from the Pension Trusts.

28. In 1960, plaintiffs, with funds of their own, and pursuant to advice of legal counsel, restored to the Trustees the funds withdrawn in 1954, 1955, 1957 and 1958 from the Pension Trusts. Upon receipt of these funds the Trustees of the Pennsylvania trusts used them to acquire annuities on the lives of plaintiffs to be owned and held in the Pension Trust.

29. In 1961, upon timely filing their individual income tax returns for the calendar year 1960, the plaintiffs claimed an overpayment of taxes beyond the amount due as follows:

John F. and Edna I. Kappel	$120,334.18
William J. and Sarah M. Kappel	261,990.87

Based upon taxes paid upon the funds received from the Pension Trusts in 1954, 1955, 1957 and 1958.

30. Pursuant to a waiver of assesment filed in 1960, in 1961 the plaintiffs paid a substantial amount of the additional tax due for the years 1954, 1955, 1957 and 1958, by reason of their receipt of the proceeds of insurance policies from the Pension Trusts in those years. The balance of said additional tax due was paid in 1963. These payments were made pursuant to assessment.

31. Plaintiffs' claims here are limited to tax liability which plaintiffs have paid on the distributions made to them from the Pension Trusts which are the product of the *employer-funded* portions of their 1954, 1955, 1957 and 1958 withdrawals. No claim is made in the present suit for any tax paid on other funds received from the pension trusts which are the product of *employee-funded* portions of the insurance policies.

32. The repayments made by the plaintiffs to the pension trusts in 1960 were reinvested by the Trustees in new annuity policies for the benefit of plaintiffs and re-established the original positions of plaintiffs in the Pension Trusts.

DISCUSSION

Plaintiffs' claims are based on the "claim of right" doctrine as established in *North American Oil Consolidated v. Burnet*, 286 U. S. 417 (1932) and codified in the provisions of Section 1341 of the Internal Revenue Code of 1954, as amended, which in its pertinent parts, provides as follows:

"§1341. Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right

(a) General rule.—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and"

.....

The pertinent Regulation is:

Treasury Regulations on Income Tax (1954 Code)

"§ 1.1341-1

(2) For the purpose of this section 'income included under a claim of right' means an item included in gross income because it appeared from all of the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and 'restoration to another' means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof)."

This is a civil suit for refund of taxes paid. The burden of proof rests upon the plaintiffs. *New Colonial Company v. Helvering*, 292 U. S. 435 (1934).

The parties dispute whether § 1341 is "exemptive" or "remedial" legislation; exemptive legislation requiring strict adherence to its terms, remedial legislation allowing liberal construction to effect the objectives sought by the legislature. The doctrine is judicial in origin. *North American Oil Consolidated v. Burnet, supra;* the statute is remedial to relieve the taxpayer from inequities resulting from the strict application of the judicial doctrine as in *United States v. Lewis,* 340 U. S. 590 (1951). See Senate Committee Report (83rd Congress, 2nd Sess. S. Rep. No. 1622 (1954) 118. Because this suit involves the right to the deduction, rather than the mechanics of taking the deduction, a strict application is warranted. *Corn Products Refining Co. v. Commissioner,* 350 U. S. 46 (1955).

Nevertheless, while the statute is remedial only in the limited sense, the "claim of right" doctrine has been described as an "equitable" doctrine. *U. S. v. Simon,* 281 F. 2d 520 (6th Cir., 1960).

To be entitled to relief under § 1341, plaintiffs have the burden of proving:

(1) That during the years 1954, 1955, 1957 and 1958, when the monies were withdrawn by them from the pension trusts they had what appeared to them at the time an unrestricted right to the monies received.

(2) That after the close of the years in which the monies were received it was established that they did not have an unrestricted right to the monies received.

(3) That they were involuntarily required to pay back the monies received earlier.

No impediment to plaintiffs' claim arises because of the fact that plaintiffs did not include the monies received from the trustee in their income tax returns for the years 1954,

1955, 1957 and 1958, because they have subsequently paid the additional income tax required for those years. This payment is a condition to the claim for deduction which forms the bases of this suit.

Before considering the first two of the above outlined essential elements, we think it helpful to our determination to consider the third factor, the conditions under which plaintiffs made their repayment to the Pension Trust in 1960. If this was done under an obligation to repay, the other elements are established for the purposes of this case.

The statute does not define the conditions of restoration or repayment except to say that it must be "esablished" that taxpayer did not have an unrestricted right to the item. The Regulations state " 'restoration to another' means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof)."

Neither the Code nor the Regulations use the language of an obligation to repay. That requirement was judicially developed prior to the adoption of the Code. Perhaps its fullest expression appears in *Crellin's Estate v. Commissioner,* 203 F. 2d 812 (9th Cir., 1953), cert. den. 346 U. S. 873. There a corporation declared and paid its stockholders a dividend under the mistaken belief that it would otherwise be subject to a surtax. Upon discovery of its mistake the corporation persuaded its shareholders to refund the dividends to decrease their own individual income tax liability. The corporation passed a resolution rescinding the dividend. A deduction in the year of repayment was denied the shareholders. The court found that the shareholders had received the dividend under a claim of

right, without restriction, under the rule established in *North American Oil Consolidated v. Burnet*, 286 U. S. 417 (1932), and that repayment was not compelled on them. The corporation having declared and paid the dividend was without power to recapture it without the shareholder's consent; thus there was no obligation to repay.

> "On the other hand, a so-called 'recission' which does not have the force and effect in law of compelling the return of payments made under a dividend declaration, but which in reality is a voluntary act, cannot create a deduction in any year." 203 F. 2d at p. 814.
>
> "In short, for tax purposes, it is that which the holding company could have compelled, not that in which the stockholders were willing to acquiesce, which controls. Otherwise, the taxpayers in this case could lift the federal tax hand to suit their convenience. See *Leich v. C. I. R.*, 8 Cir., 1943, 137 F. 2d 433, 435. We recognize that action may be taken by a party which results in a tax saving providing the action is authorized by law. But substance prevails over form. The consent given by petitioners and relied upon by them as justifying 'recission' was in fact no more than a voluntary payment by stockholders." 203 F. 2d at p. 815.

Our examination of the cases reveals that an element of compulsion of repayment is present in the decisions under the claim of right doctrine. In *United States v. Lewis*, 340 U. S. 590 (1951), where the relief was denied to the taxpayer solely because he was limited to a deduction in the year of repayment, nevertheless the obligation to repay was established by litigation and a judgment rendered against the taxpayer.

The compulsion need not be the judgment of a court, but there must be a clear showing, under State statutes or decisions, of the taxpayer's liability to repay, *Joseph S. Pike,* 44 T. C. 787. In *Pike,* the Tax Court denied relief under Section 1341 because, *inter alia,* he was not compelled by legal process to make the payment, and had failed to prove that he was not entitled to retain the item received; nevertheless his payment was not voluntary in the sense of being gratuitous, being made for a bonafide business purpose, and the Tax Court allowed the deduction as an ordinary and necessary business expense under Section 162(a).

While stating that it did not intend to hold that a payment was involuntary only if pursuant to a judgment, Revenue Ruling 58-456 allowed a Section 1341 deduction where repayment was pursuant to a judgment secured against a corporation and its stockholders by the Federal Housing Administrator for improper disposition of mortgage proceeds. However, it was noted that, "for example, if repayment is made pursuant to a demand by the Federal Housing Administration under circumstances entitling such Administration to enforce the demand by legal action in the absence of compliance, such repayment would be considered as involuntary.".

The nature of the compulsion is further illustrated in *Haberkorn v. United States,* 173 F. 2d 587 (6th Cir., 1949). decided before the 1954 Code under the rule of *North American Oil Consolidated v. Burnet, supra.* There an employee had been paid a salary and bonus of a percentage of net income in 1942 upon which the income tax was paid. In 1944, the employer discovered an error in the calculation of 1942 profits, and charged the employee's account with the overpayment. The court held that a debtor-creditor relationship was established by this action which created

an obligation to repay in that year the overpayment which the taxpayer had received without restriction and absolutely in 1942.

It has been held that "a condition precedent to the applicability of this section (Section 1341) is the ability of the taxpayer to take a deduction in the year of repayment under other provisions of the Code." *National Life and Accident Insurance Co. v. United States,* 244 F. Supp. 135 (M. D. Tenn., 1965). This conclusion is supported by that court by the pattern of the statutory scheme of deductions allowable, the legislative intent to give relief by allowing the deduction in the year of repayment, and the specific use of the word "deduction" in Section 1341, and in Regulations 1.1341-1.

The same conclusion is urged upon us by the holding of *United States v. Simon,* 281 F. 2d 520 (6th Cir., 1960). There a partnership was the owner of real estate which it leased to a corporation whose stock was wholly owned by the partnership. When the Internal Revenue Service determined that the rental payment by the corporation was excessive the lessor refunded to the corporation the excess over the rental deduction allowed in prior years. The court found that when the rental was refunded, taxpayers were under no legal or moral obligation to do so. It also found:

> "We fail to see any business purpose in making the modification agreement retroactive so as to provide for refunding of rentals already paid in a prior tax year. The sole reason, in our judgment, was to obtain a tax advantage either for the corporation, or taxpayers or both. This is not sufficient to justify the deduction claimed as payment of an 'obligation' within the sense of claim of right. We agree with the

> decisions previously discussed which hold that no 'obligation' arises from a voluntary agreement to repay monies which the taxpayer would otherwise have an absolute and unconditional right to retain." (p. 526).

The court also found that the deductions could not be considered as necessary expenses in carrying on a trade or business within the meaning of the statute, 26 U. S. C. 23 (1954 Code, Section 163) because it served no business purpose.

The defendant has urged the holding in *Commissioner v. Gilt Edge Textile Corp.*, 173 F. 2d 801 (3rd Cir., 1949) as strong authority for denial of the deduction. *Gilt Edge* concerned a payment by a corporation to its president to enable him to satisfy a judgment against him personally because of mismanagement of an estate. The mismanagement included a preferential transfer of an estate asset to the corporation. The Court of Appeals in reversing the Tax Court's allowance of a deduction, found the payment voluntary with no threat of litigation being made against the corporation, without regard to the defense which the corporation might impose to any such claim, without business benefit to the corporation, without regard to the possibility of the corporation securing indemnification for any payment compelled upon it, and even without the support of moral obligation. However, *Gilt Edge* must be restricted to its actual holding. There was no "claim of right" basis for the deduction asserted; the deduction was claimed and disallowed solely under Section 23(f) *Losses by Corporations,* for a loss sustained during the taxable year and not compensated by insurance or otherwise. (1954 Code Sec. 165.) The court specifically limited consideration of the claim to the fixed scope of applicability of Section 23(f). At no point was the "claim of right" doctrine considered.

A great variety of cases have been cited to the court as illustrations of both the voluntary and involuntary nature of such repayments. Some of them do not concern deductions under "claim of right" payments, but rather deal with the allowance of deductions for repayments made during the same tax year as received, or allowance of deductions for repayments in years subsequent to receipt under other sections of the Code. They present little controlling authority on the question at issue here, except for the common theme of determining whether payment is made under obligation, and whether it is made for a purpose otherwise allowable for deduction under other sections of the Code, that is, for a bona fide business purpose, or a benefit to the taxpayer other than a tax saving.

It is of interest to note the practical effect of the repayment here by plaintiffs. By their repayment to the Pension Trust, they relinquished nothing but the present power of absolute control. The monies repaid to the Trust were immediately reinvested in insurance annuity contracts in their names and for their benefit, which could be repaid to them under the terms of the Trust Indenture upon their request, in installments, or paid to their beneficiaries upon their death. Their repayment was a postponement of present enjoyment, but no loss in their vested rights under the pension plan. We are disturbed by classification of this as "repayment", for the funds repaid will be held for their benefit, and will not go to the benefit or enjoyment of any other party.

We find no business considerations or economic benefits in this case sufficient to support any deduction under any other section of the Code. Our inquiry then is directed to the question of whether there was an enforcement obligation to repay.

The obligation to repay must be examined from the evidence in this case, and under the applicable law of Pennsylvania, the situs of the Pension Trusts. There is no evidence here that plaintiffs were forced to repay by judicial process. No judicial process was instituted. There was no specific threat of litigation. At most the evidence shows that the Trustees, which included the plaintiffs, instructed counsel, which was also counsel for the plaintiffs, to undertake the steps necessary to see that the Pension Trust was administered according to its terms and according to law. The counsel took elaborate, extensive and thorough steps to see that matters were restored to the status in which they were before the withdrawals. This included threats of litigation against insurance companies which had received the trust proceeds to invest in annuity contracts for taxpayer's relatives, under the doctrine of tracing funds impressed with a trust. They were successful in restoring the *status quo* after what appears to have been a monumental effort.

But under the law of Pennsylvania relating to trust administration, what compulsion could have been placed upon plaintiffs to restore? They had not impaired the trust *res* by withdrawing their funds; each individual beneficiary's share was administered as a separate trust. No other beneficiary suffered any harm, and no beneficiary had standing to sue, either by suit against the beneficiaries directly, or against the Trustees. Similarly, the Trustees and the settlors had acquiesced in the violation of the trust terms, they could not sue as trustees or settlors, nor could they sue on behalf of any beneficiary because no beneficiary had suffered harm. See II, Scott on *Trusts*, 2d Ed. Section 205; Restatement, *Trusts*, 2d Section 256.

We have found no Pennsylvania cases where a beneficiary has been held liable to repay in the absence of a loss to other beneficiaries.[1]

Plaintiffs have cited cases from Pennsylvania that indicate that a trust cannot be altered by the agreement of the Trustees and all beneficiaries. But these all involve the elements of testamentary trusts, where the court is motivated by the purpose of carrying out the testator's intent, see *Cannistra's Estate*, 384 Pa. 605, 125 A. 2d 157 (1956). *Grote's Estate*, 390 Pa. 261, 135 A. 2d 383 (1957), was not technically a testamentary trust, but an *inter vivos* trust where the settlor had died but the same rationale determined that decision. In the present case we not only have *inter vivos trusts*, but the beneficiaries were the controlling officers and stockholders of the settlors, and they reserved to the trustees, including themselves and others over whom they held a power of control, the right to alter, amend or terminate the Pension Trust. They had passed the age of eligibility, their rights were vested, their enjoyment of the benefits was subject to their own option.

Under these facts, it is difficult to find any power of compulsion. Although moral obligation has been rejected as a basis allowing deduction for repayment, see *United States v. Simon, supra*, we cannot find any moral obligation here in the sense of an obligation to restore to another that which he has lost but cannot recover by legal action.

We, therefore, conclude that the evidence fails to prove that the plaintiffs made the payments in question under any obligation to repay.

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[1] In *Maloney v. Glosser*, 427 Pa. 548, 235 A. 2d 607 (1967), the trial court ordered repayment as incidental to injunctive relief to prevent further improper diminution of the trust funds, and because the payment was to the detriment of the Trust.

CONCLUSIONS OF LAW

1. This Court has jurisdiction of this matter pursuant to 28 U. S. C. 1346 (a) (1).

2. The payments made by plaintiffs to the Trustees of the several Pension Trusts in 1960, for which a claim for deduction is made in this case, were not made under any obligation of repayment because it was established in 1960 that plaintiffs did not have an unrestricted right to the income received from this source in prior years.

3. Plaintiffs's claims for relief under 26 U. S. C. 1341 have not been established by a preponderance of evidence in this case.

4. Judgment shall be entered in each of the above cases for Defendant upon the claim for relief under 26 U. S. C. 1341, dismissing the complaint with prejuidice and awarding costs to the Defendant

---

ORDER

AND NOW this 22nd day of March, 1968, Defendant shall prepare and submit to this court a form of judgment order in accordance with the findings of the Court, with ten days notice to plaintiffs of its presentation.

GERALD J. WEBER,
United States District Judge.

APPENDIX D

Memorandum Opinion

Civil Action No. 64-1091.

Civil Action No. 64-1092.

(Filed January 16, 1970.)

WEBER, *J.*

In each case Plaintiff has moved under Fed. R. of Civ. P. 52 and 59 to amend findings of fact, to alter or amend judgment and for a new trial of this case.

The motion for new trial is largely based on allegations of extensive harm to third-parties, the settlor corporations and their stockholders, participating employees, and beneficiaries of the pension trusts involved if our judgment is allowed to be entered and become final. These dire consequences are such as would follow the loss of their status as a qualified trust by action of the Internal Revenue Service.

We see no need for a new trial to receive such evidence because we had no question before us as to the status of these trusts as qualified exempt pension trusts. We see no consequence of our decision that leads to a determination of the disqualification of these trusts and in fact the proceedings which raised the question of disqualification were first instituted by the Internal Revenue Service in 1965 concerning the contributions made to the trusts from income in the year 1963, when the recovery sought in the present case concerns the year 1960. Furthermore, it was not our decision in 1968 which incited the Internal Revenue Service in 1966

It appears from the memorandum of the Internal Revenue Service Pension Trusts Section of November 15, 1966 that the bases of the Internal Revenue Service action was that withdrawals were permitted from the funds prior to the severance of the beneficiary's employment, and that lump sum payments were made to the plaintiff's in contravention of the terms of the trust. It was the position of the Internal Revenue Service that the pension trusts were disqualified when the illegal withdrawals were made in the years 1954 through 1958. This factual situation was also the starting point of the present suit. Taxpayer insisted that the repayment of the "illegal" withdrawals in 1960 was made under an obligation to repay. At the time of argument the obligation to repay that was advanced was the possible threat of action by other beneficiaries of the trust whose interest in the trust *res* was impaired. The new argument pressed is the threat of compulsion to repay by other beneficiaries, or the settlor corporation, because the plaintiffs' actions impaired the tax benefits enjoyed by the settlor corporation and the participants. Of course there was no such threat existing in 1960, either by other beneficiaries who could allege impairment of the trust *res*, or by those affected by the loss of tax benefits first raised as to 1963 income.

We see no need for a new trial to secure evidence of the consequences of loss of tax shelter. For the purposes of our decision we accept the fact that such consequences would follow. We might note that the possibility of requalification could be pursued because of the single nonrecurring type of transaction which led to the disqualification.

In any event it was not our determination in this case which established any disqualification of the trust. These

determinations are made by the Internal Revenue Service pursuant to their statutory and regulatory standards.

With respect to the motion to amend findings we see no reason to amend findings of fact numbered 7, 8, 16 and 24. They correctly reflect the evidence of record. They do not recite addition evidence because such additional facts were immaterial to the legal conclusions reached. Nor do we find that they cast any intimations of culpability on plaintiffs. Other findings clearly indicate that plaintiffs were merely following the guidance of their pension plan consultant.

With respect to findings of fact numbered 27 we did not include a finding that no legal action was instituted to compel repayment because repayment had in fact been made. There is no evidence to support this, although such a conclusion may be argued as a logical consequence of repayment. More important for our decision was the fact that there was no evidence that any other employees even knew of the transaction.

It is asserted that the court erred in finding that there were separate pension trusts for each employee. We think that a reading of findings of fact numbered 7, 8 and 9 clearly indicate our understanding that there were four separate trusts, one for each corporation, but that each participating employee received investments in separate and individual insurance policies for his individual benefit. Thus the interest of each beneficiary was secured by his own policy and was unaffected by transactions concerning the policies of other employees, including the plaintiffs. [See finding of fact numbered 13].

We made no finding that the pension trusts were qualified as exempt plans by the Internal Revenue Service because it was immaterial to our decision, and now that this

contention has been advanced as a second ground in support of plaintiffs' obligation to repay, we continue to regard it as not material. It was not the repayment which caused the Internal Revenue Service to take its action in 1965, but the initial withdrawals.

The many amendments which plaintiffs seek in our findings of fact we deem immaterial to the question which was before us for decision. Some of the facts which plaintiffs seek to have incorporated into our findings are contained in the record and are capable of being proved again in a separate proceeding to which they are material. We do not feel it proper on our part to make findings on matters which are not material to our decision, when such evidence may be considered by another tribunal in a matter under its jurisdiction. The Internal Revenue Service must determine the qualified status of those present trusts according to their own statutory and regulatory standards, and the evidence before them.

We affirm our conclusion that there was no evidence sufficient to prove that plaintiffs made repayment here under an obligation to repay sufficient to entitle them to relief under Section 1341.

ORDER.

AND NOW January 16, 1970, Motion of Plaintiffs to Amend Findings of Fact, to Amend or Alter Judgment, and for a New Trial are DENIED, and the Clerk is DIRECTED to enter judgment for Defendant in each of the above cases.

GERALD J. WEBER,
United States District Judge.

APPENDIX E

Judgment on Decision by the Court

Civil Action File No. 64-1091

(Filed January 19, 1970.)

This action came on for trial before the Court, Honorable Gerald J. Weber, United States District Judge, presiding, and the issues having been duly tried and a decision having been duly rendered,

It is Ordered and Adjudged that judgment be entered for the defendant, The United States of America, and against the plaintiffs, John F. Kappel and Edna I. Kappel.

Judgment is hereby entered accordingly.

Dated at Pittsburgh, Pennsylvania, this 19th day of January, 197

JAMES J. WALLACE, JR.,

djr

Clerk of Court.

APPENDIX F

Judgment on Decision by the Court.

Civil Action File No. 64-1092.

(Filed January 19, 1970.)

This action came on for trial before the Court, Honorable Gerald J. Weber, United States District Judge, presiding, and the issues having been duly tried and a decision having been duly rendered,

It is Ordered and Adjudged that judgment be entered in favor of the defendant, The United States of America, and against the plaintiffs, William J. Kappel and Sarah M. Kappel.

Judgment is hereby entered accordingly.

Dated at Pittsburgh, Pennsylvania, this 19th day of January, 1970.

JAMES J. WALLACE, JR.,

djr

Clerk of Court.

APPENDIX G

Relevant Statutes and Regulations

STATUTES.

Internal Revenue Code of 1954, As Amended:

26 United States Code

(Statute Sections and USC Sections are Identical)

	PAGE
Section 162	39a
Section 165	40a
Section 401	41a
Section 501	43a
Section 503	44a
Section 1341	46a
Section 2039	47a
Section 2517	49a

INTERNAL REVENUE RULINGS, ETC.

G. C. M. 16730 (General Counsel Memorandum)	51a
Revenue Ruling 55-297	56a
Revenue Ruling 58-456	57a
Revenue Ruling 67-9	66a
Revenue Ruling 68-662	68a
Revenue Ruling 70-315	71a

§ 162. Trade or Business Expenses

(a) *In general.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

§ 165. Losses

(a) *General rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on losses of individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;

§ 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS

(a) *Requirements for qualification.*—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a) (3) (B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

(3) if the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

(A) 70 percent or more of all the employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum peri-

od prescribed by the plan, not exceeding 5 years, employees whose customary employment is for not more than 20 hours in any one week, and employees whose customary employment is for not more than 5 months in any calendar year, or

(B) such employees as qualify under a classification set up by the employer and found by the Secretary or his delegate not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees;

and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(5) A classification shall not be considered discriminatory within the meaning of paragraph (3) (B) or (4) merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 3121(a) (1) (relating to the Federal Insurance Contributions Act) or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, or merely because the contributions or benefits based on that part of an employee's remunera-

tion which is excluded from "wages" by section 3121(a) (1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law. For purposes of this paragraph and paragraph (10), the total compensation of an individual who is an employee within the meaning of subsection (c) (1) means such individual's earned income (as defined in subsection (c) (2)), and the basic or regular rate of compensation of such an individual shall be determined, under regulations prescribed by the Secretary or his delegate, with respect to that portion of his earned income which bears the same ratio to his earned income as the basic or regular compensation of the employees under the plan bears to the total compensation of such employees.

(6) A plan shall be considered as meeting the requirements of paragraph (3) during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements.

§ 501. Exemption from Tax on Corporations, Certain Trusts, Etc.

(a) *Exemption from taxation.*—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

(b) *Tax on unrelated business income.*—An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in part II of this subchapter (relating to tax on unrelated income), but, notwithstanding part II, shall be considered an organization

exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

. . .

§ 503. REQUIREMENTS FOR EXEMPTION

(a) *Denial of exemption to organizations engaged in prohibited transactions*

(1) *General rule.*—

. . .

(C) An organization described in section 401(a) which is subject to the provisions of this section shall not be exempt from taxation under section 501(a) if it has engaged in a prohiibted transaction after March 1, 1954.

(2) *Taxable year affected.*—An organization described in section 501(c) (3) or (17) or section 401(a) shall be denied exemption from taxation under section 501(a) by reason of paragraph (1) only for taxable years after the taxable year during which it is notified by the Secretary or his delegate that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.

. . .

(c) *Prohibited transactions.*—For purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section—

(1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) makes any part of its services available on a preferential basis to;

(4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267(c) (4)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

(d) *Future status of organizations denied exemption.*— Any organization described in section 501(c) (3) or (17) or section 401(a) which is denied exemption under section 501(a) by reason of subsection (a) of this section, with respect to any taxable year following the taxable year in

which notice of denial of exemption was received, may, under regulations prescribed by the Secretary or his delegate, file claim for exemption, and if the Secretary or his delegate, pursuant to such regulations, is satisfied that such organization will not knowingly again engage in a prohibited transaction, such organization shall be exempt with respect to taxable years after the year in which such claim is filed.

. . .

§ 1341. Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right

(a) *General rule.*—if—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

§ 2039. ANNUITIES

(a) *General.*—The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

(b) *Amount includible.*—Subsection (a) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. For purposes of this section, any contribution by the decedent's employer or former employer to the purchase price of such contract or agreement (whether or not to an employee's trust or fund forming part of a pension, annuity, retirement, bonus or profit sharing plan) shall be considered to be contributed by the decedent if made by reason of his employment.

(c) *Exemption of annuities under certain trusts and plans.*—Notwithstanding the provisions of this section or of any provision of law, there shall be excluded from the gross estate the value of an annuity or other payment receivable by any beneficiary (other than the executor) under—

(1) an employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of the decedent's separation from employment (whether by death or otherwise), or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(2) a retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of decedent's separation from employment (by death or otherwise), or at the time of termination of the plan if earlier, was a plan described in section 403(a);

(3) a retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 503(b) (1), (2), or (3), and which is exempt from tax under section 501(a); or

(4) chapter 73 of title 10 of the United States Code.

If such amounts payable after the death of the decedent under a plan described in paragraph (1) or (2), under a contract described in paragraph (3), or under chapter 73 of title 10 of the United States Code are attributable to any extent to payments or contributions made by the decedent, no exclusion shall be allowed for that part of the value of such amounts in the proportion that the total payments or contributions made by the decedent bears to the total

payments or contributions made. For purposes of this subsection, contributions or payments made by the decedent's employer or former employer under a trust or plan described in paragraph (1) or (2) shall not be considered to be contributed by the decedent, and contributions or payments made by the decedent's employer or former employer toward the purchase of an annuity contract described in paragraph (3) shall, to the extent excludable from gross income under section 403(b), not be considered to be contributed by the decedent. This subsection shall apply to all decedents dying after December 31, 1953. For purposes of this subsection, contributions or payments on behalf of the decedent while he was an employee within the meaning of section 401(c) (1) made under a trust or plan described in paragraph (1) or (2) shall be considered to be contributions or payments made by the decedent.

. . .

§ 2517. Certain Annuities Under Qualified Plans

(a) *General rule.*—The exercise or nonexercise by an employee of an election or option whereby an annuity or other payment will become payable to any beneficiary at or after the employee's death shall not be considered a transfer for purposes of this chapter if the option or election and annuity or other payment is provided for under—

(1) an employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of such exercise or nonexercise, or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(2) a retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to

a plan which, at the time of such exercise or non-exercise, or at the time of termination of the plan if earlier, was a plan described in section 403(a);

(3) a retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 503(b) (1), (2), or (3), and which is exempt from tax under section 501(a); or

(4) chapter 73 of title 10 of the United States Code.

(b) *Transfers attributable to employee contributions.*—If the annuity or other payment referred to in subsection (a) (other than paragraph (4)) is attributable to any extent to payments or contributions made by the employee, then subsection (a) shall not apply to that part of the value of such annuity or other payment which bears the same proportion to the total value of the annuity or other payment as the total payments or contributions made by the employee bear to the total payments or contributions made. For purposes of the preceding sentence, payments or contributions made by the employee's employer or former employer toward the purchase of an annuity contract described in subsection (a) (3) shall, to the extent not excludable from gross income under section 403(b), be considered to have been made by the employee. For purposes of this subsection, payments or contributions on behalf of an individual while he was an employee within the meaning of section 401(c) (1) made under a trust or plan described in subsection (a) (1) or (2) shall be considered to be payments or contributions made by the employee.

(c) *Employee defined.*—For purposes of this section, the term "employee" includes a former employee.

ARTICLE 331: When included in gross income. XV-25-8130
(Also Section 43, Article 342.) G. C. M. 16730

REVENUE ACT OF 1928.

Where A, who kept his books on the cash receipts and disbursements basis, received income under a claim of right and without restriction as to its disposition, such income was properly reported in his income tax returns for the years in which received, although he was subsequently required to pay the amount to another. He is, however, entitled to a deduction for the amount of such payment for the year in which paid.

G. C. M. 1582 (C. B. VI-1, 171) modified. Recommended that O. D. 825 (C. B. 4, 95) and I. T. 1164 (C. B. I-1, 17) be revoked and that O. D. 1141 (C. B. 5, 134) be modified.

An opinion is requested whether certain profits included in the taxpayer's income tax returns for the years 1928 and 1929 should be eliminated therefrom because in a later year he was required to account for such profits to another.

In 1928 the taxpayer, A, who kept his books on the cash receipts and disbursements basis, was a director of the M Company. In that year it was essential for the M Company to acquire rights to manufacture under certain basic patents and it was believed that such rights might be acquired through the N Company, then in receivership. It developed that this purpose might be accomplished by the M Company acquiring y shares of N Company stock. Later it appeared that the M Company could not raise the funds with which to purchase this stock (or so it was claimed) and the stock was acquired by a number of persons, including the taxpayer, who made large profits in 1928 and 1929 dealing in the shares. The M Company later

went into bankruptcy and the trustee brought suit against the taxpayer and his associates to compel them to account for the profits realized from their dealings in the N Company stock. The basis of the suit was that the profit was made in violation of the defendants' fiduciary duty as officers and agents of the M Company. The taxpayer denied liability. The trial court decided in favor of the defendants but its decree was reversed by the circuit court as against the taxpayer and certain other defendants. Certiorari was denied by the United States Supreme Court.

The taxpayer reported as income for the years 1928 and 1929 his profits from the sale of the stock, but now contends that such profits should be eliminated from income for those years because of the adverse judgment rendered in a later year.

It is well settled that when a taxpayer receives earnings under a claim of right and uses them as his own, he has received income which he is required to return, for Federal income tax purposes, in the year of receipt even though another may be asserting a right to those earnings and may subsequently, by litigation or otherwise, compel him to pay them over. (*North American Oil Consolidated v. Burnet,* 286 U. S., 417, Ct. D. 499, C. B. XI-1, 293; *Board v. Commissioner,* 51 Fed. (2d), 73, certiorari denied, 284 U. S., 658; *Trojan Oil Co. v. Commissioner,* 26 B. T. A. 659.)

In *North American Oil Consolidated v. Burnet, supra,* the taxpayer, in 1916, was operating certain oil properties legal title to which stood in the name of the United States. The Government, claiming also the beneficial ownership, instituted suit to oust the taxpayer from possession and in 1916 secured the appointment of a receiver to operate the property and to hold the net income thereof. In 1917

a decree was entered dismissing the bill and the money impounded was paid to the defendant corporation. The Government took an appeal, which was not finally determined until 1922. The court held that the taxpayer should report the amount as income for 1917, when it collected it, and not for 1922, when its right was finally established. In so holding the court said:

> * * * If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. (See *Board v. Commissioner,* 51 F. (2d), 73, 75, 76. Compare *United States v. S. S. White Dental Mfg. Co.,* 274 U. S., 398, 403.) If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. (Compare *Lucas v. American Code Co., supra.*)

Board v. Commissioner, supra, affords another illustration of the rule that income received under a claim of right and without restriction as to disposition must be reported in the year of receipt. In that case corporation O sold all of its assets and went into liquidation. At that time O had entered into a contract for the construction of a pipe line. The other party to the contract was unable to finance his part of the agreement. The project was taken over by the liquidating trustees and two other officers and constructed on the joint credit of O and those individuals. Upon the sale of the properties of O the liquidating trustees distributed a part of the proceeds to the officers and other liquidating

trustees in 1920. Certain stockholders contested this distribution and filed an action which was not finally settled until 1927. In holding that the taxpayer was required to report the amount as income for 1920 rather than for 1927, the court stated in part as follows:

> We are of the opinion that the Board was right in allocating this income to the year 1920. That it was actually received during that year is not disputed; nor is it disputed that it was received under a claim of right and as profits to which the petitioner was justly entitled. The only claim made is that the contract whereby petitioner purported to secure his interest in the pipe line was illegal and unenforceable by reason of his position as a director of the Old Dominion Oil Co. In this contention the petitioner of course never acquiesced. The payment was never refunded. Possibly it might have been recovered in the litigation which was instituted for that purpose, but it was not, and it is at least unusual that a taxpayer should be heard to assert the possibility of an adjudication of alleged misconduct and breach of trust, as relieving him from tax liability which is predicated upon the assumption of the honesty and legality of his acts. Obviously, the sum involved must be considered as income either for the year 1920 or 1927, and we think that it must be allocated to the year 1920, in which it was actually received, rather than to the year 1927, in which the taxpayer's right to retain it was established.

In the Trojan Oil Co. case a similar conclusion was reached under circumstances closely analogous to those presented in *North American Oil Consolidated v. Burnet, supra*, although the litigation terminated in a later year unfavorably to the taxpayer. The Board commented as follows:

> Although in the instant case more than one year's earnings were impounded and the litigation was decided in favor of the Government, we think the decision in the *North American Consolidated* case governs in this case. * * *

In the instant case the taxpayer received the income under a claim of right and without restriction as to its disposition. On authority of the cases cited herein, this office is of the opinion that the profits in question should not be eliminated from the taxpayer's gross income for the years 1928 and 1929, but that the taxpayer is entitled to a deduction, for the year in which paid, of the amount of the profits paid to the trustee for the M Company.

G. C. M. 1582 (C. B. VI-1, 171) is modified in so far as it is inconsistent with the views herein expressed. It is recommended that O. D. 825 (C. B. 4, 95) and I. T. 1164 (C. B. I-1, 17) be revoked and that O. D. 1141 (C. B. 5, 134) be modified in so far as it is inconsistent with the views herein expressed.

HERMAN OLIPHANT,
General Counsel for the Department of the Treasury.

REGULATIONS 118, SECTION 39.165-2: Impossibility of diversion under the trust instrument

Rev. Rul. 55-297

An employee's rights under a pension or profit-sharing plan meeting the requirements of section 165(a) of the Internal Revenue Code of 1939 are matters covered by the terms of the plan and/or trust agreement and the provisions of local law. The enforcement of such rights is not a responsibility of, nor within the jurisdiction of, the Internal Revenue Service. The jurisdiction of the Internal Revenue Service with respect to pension, etc., plans is limited to determinations whether the plans meet the appplicable requirements of the Internal Revenue Code, whether amounts claimed as deductions from gross income for contributions or payments to or under such plans are allowable, and as to the tax effect upon employees of such contributions to, and the distributions by or pursuant to, such plans or trusts.

Advice has been requested concerning the employee's rights under a pension plan, meeting the requirements of section 165(a) of the Internal Revenue Code of 1939, and the assistance that may be made available from the Internal Revenue Service in the enforcement of such employee's rights.

An employee participant in a pension plan, funded through a trust with a national bank as trustee, separated from the service of his employer and, under the provisions of the plan whereby every employee with 4 years of service who terminates his services prior to age 65 is entitled to a prescribed percentage of the employer's contributions on his behalf, was vested with a certain definite interest in the

trust fund. It is claimed, however, that the employer, being unable to control the funds of the trust, demanded that the employee sign over to the employer the funds contributed by the employer because of the employee's separation from service.

An employee's rights under a pension, etc., plan are matters covered by the terms of the plan and/or trust agreement and the provisions of local law in regard thereto. The enforcement of such rights is neither a responsibility of, nor in any respect within the jurisdiction of, the Internal Revenue Service.

The jurisdiction of the Service with respect to pension, etc., plans is limited to determinations whether the plans meet the applicable requirements of the Code, whether amounts claimed as deductions from gross income for contributions or payments to or under such plans are allowable, and as to the tax effect upon employees of such contributions to, and the distributions by or pursuant to, such plans or trusts. In making such determinations, consideration must be given to the actual operation of the plan, and in a case such as this it would of course be necessary to treat any assignment by the employee to the employer of the employee's vested interest in the trust fund as a reversion to the employer which is prohibited by section 165(a)(2) of the Code.

Rev. Rul. 58–456

During the taxable year 1952, a corporation distributed to its stockholders the excess of the proceeds of mortgage loans insured by the Federal Housing Administration over the construction cost of the property covered by the loans. Each of the stockholders

reported the excess of the amount received over the cost or other basis of their respective shares of stock in the corporation as a long-term capital gain in that taxable year. In 1957, the stockholders involuntarily repaid to the corporation all of such amounts received in 1952, which amount, in each case, was in excess of $3,000. *Held*, the amounts repaid to the corporation by the stockholders constitute allowable deductions for 1957 and entitle the stockholders to adjustments under section 1341 of the Internal Revenue Code of 1954 to the extent that they were reflected in gross income for 1952. The basis of the stock in the hands of the stockholders is restored, but only to the extent that such basis was previously applied against the amounts received in determining the gains reported for 1952. Further, interest, if any, paid or due on any deficiency properly determined for 1952, with respect to a stockholder, does not enter into the computation of the decrease in tax under section 1341 (a) (5) (B) of the Code.

Advice has been requested relative to the application of section 1341 of the Internal Revenue Code of 1954 to payments made by the taxpayer to a corporation of which he is a substantial stockholder under the circumstances described below.

The taxpayer owns 25_X shares of the common stock of a corporation which has outstanding common stock of 200_X shares. The corporation was properly organized under state law for the purpose of constructing and operating rental property pursuant to the National Housing Act, as amended, 48 Stat. 1246, 12 U. S. C. 1701. In order to qualify for insurance under the Act and to obtain the mortgage insurance benefits provided for therein, the corpora-

tion adopted a charter which, in all material aspects, followed the form prescribed by the Commissioner of the Federal Housing Administration. As part of the insurance plan, the Commissioner of the Federal Housing Administration, at a nominal cost of $1.00 per share, acquired all of the preferred stock of the corporation. The corporate charter adopted by the corporation restricted the payment of dividends to net earnings and also prohibited the assignment, transfer, disposition or encumbrance of any real or personal property of the corporation without the consent of the preferred stockholder.

The corporation, under section 608 of the Act, as amended, 56 Stat. 303, 12 U. S. C. 1743, obtained loans on notes secured by Federally insured mortgages on the properties. Although there was no apparent fraud or misrepresentation by the corporation in its relations with the Federal Housing Administration, the actual cost of construction of the project was less than the amount of the insured loans. During the taxable year 1952, and soon after completion of the project, the board of directors of the corporation, by resolution, authorized the distribution of the unexpended proceeds of the mortgage loans to the common stockholders of the corporation. Distribution was made in 1952. The amount so distributed was paid exclusively out of the excess mortgage proceeds; the corporation having neither current nor accumulated earnings and profits. Each stockholder reported, as a long-term capital gain, for the taxable year 1952, the excess of the amount thus received over the basis of his stock in the corporation.

The Federal Housing Administration determined that the corporate charter prohibited the distribution referred to above and formally declared a default under the terms of

the loan agreement and proceeded to take the necessary action to assume control of the corporation in accordance with the procedure set up in the charter of the corporation. The corporation and the individual common stockholders thereupon instituted an action in the United States District Court seeking to restrain the Commissioner of the Federal Housing Administration from holding special meetings of the preferred stockholders, the purpose of which meetings was to elect new directors because of the alleged violation of the corporation's charter. The court sustained the proposed action of the Commissioner of the Federal Housing Administration and ruled that the corporation's charter restricted dividends to net earnings and that the distribution of the excess mortgage proceeds violated the provisions of the corporate charter.

In 1957, an action was brought by the United States and the Commissioner of the Federal Housing Administration against the corporation and its common stockholders seeking to compel them to repay to the corporation the excess mortgage proceeds. The court ordered the stockholders to pay back to the corporation all of the excess mortgage proceeds previously distributed by the corporation. The court further directed the corporation to set aside such amounts in a special reserve account which would not be available for dividends to stockholders without the approval of the Commissioner of the Federal Housing Administration. The stockholders, in 1957, repaid such amounts in cash to the corporation, the amount in each case being in excess of $3,000.

Section 1341 of the Internal Revenue Code of 1954 provides, in part:

(a) GENERAL RULE.—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

For the purposes of paragraph (5)(B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income).

In *Estate of Lloyd E. Crellin et al. v. Commissioner*, 17 T. C. 781, affirmed, 203 Fed. (2nd) 812, certiorari denied, 346 U. S. 873, the directors of a personal holding company in which the petitioners were stockholders declared and paid a dividend approximately equal to the capital gain which had been realized upon the sale of certain of its securities. The dividend was declared and paid by the corporation after the directors were advised that, in the opinion of a certified public accountant, the gains, unless distributed, would be subject to the personal holding company surtax. Later in the year, the directors were informed that the opinion of the accountant had been erroneous, whereupon they adopted a resolution purporting to rescind the declaration and payment of the dividend. After such action by the directors, and in the same year, the petitioners made payments to the corporation equal to the dividend payments previously received. The Tax Court of the United States held that neither the action of the directors nor the repayment by the stockholders of the amounts previously received changed the character of the dividend payments so as to permit their exclusion from gross income or their deduction by the petitioners of the amounts paid.

The United States Court of Appeals, in affirming the decision of the Tax Court of the United States in the *Crellin* case, stated that:

In short, for tax purposes, it is that which the holding company could have compelled, not that in which the stockholders were willing to acquiesce, which controls. Otherwise, the taxpayers in this case could "lift the federal tax-hand" to suit their convenience. * * * We recognize that action may be taken by a party which results in a tax saving provided the action is authorized by law. But substance prevails over form. The consent given by the petitioners

and relied upon them as justifying "recission" was in fact no more than a voluntary payment by stockholders. The judgment of the Tax Court is affirmed.

In *Charles Kay Bishop et al. v. Commissioner*, 25 T. C. 969, acquiescence, C. B. 1956–1, 3, a minority stockholder of a corporation claimed that the majority stockholders, who were partners in two other businesses similar to the corporation's business, were illegally diverting the corporate profits to the partnership businesses in a manner detrimental to the corporation. As a result of the settlement of the controversy the partnership assets were transferred to the corporation on December 31, 1946, as of January 1, 1946. One of the questions there to be resolved was whether the partners were required to report the 1946 income of the two partnerships which they transferred to the corporation as part of the settlement. The Tax Court found that the partnership income rightfully belonged to the corporation and that the partners were not required to report the income in their individual returns.

The Tax Court distinguished the *Bishop* case from the *Estate of Lloyd Crellin, supra,* on the basis that in the *Crellin* case there was a voluntary return of a dividend, whereas in the *Bishop* case there was no voluntary repayment but instead the partners recognized the superior claim of the corporation to the income earned from the partnership businesses.

In the instant case, the repayment was involuntary, being made pursuant to a judgment by the court. Thus, the principles of the *Bishop* case are applicable. That is not to say that a repayment is involuntary only if made pursuant to a judgment. For example, if repayment is made pursuant to a demand by the Federal Housing Administration under circumstances entitling such Administration to enforce the

demand by legal action in the absence of compliance, such repayment would be considered as involuntary.

Section 1341 of the Code, as indicated above, provides that the tax imposed for the taxable year shall be the lesser of (a) the tax for the taxable year computed with the deduction for repayment or (b) an amount equal to (1) the tax for the taxable year computed without such deduction minus (2) the decrease in tax under Chapter 1 of the Code (or corresponding prior law) for the prior taxable year which would result from the exclusion of such item from gross income for such prior taxable year. Under the first method there is no recomputation of tax for the earlier year. Under the second method the tax for the earlier year is recomputed. Such recomputation for the earlier year does not mean, however, that there is any refund of tax due the taxpayer for such earlier year. Rather, the recomputation for the earlier year is made solely for the purpose of determining the tax liability for the year of repayment. The deficiency, if any, asserted against the taxpayer for the earlier taxable year remains unchanged and must be satisfied by payment or credit.

Under section 6601 of the Code, interest runs on the deficiency until it is satisfied, except for any temporary suspension under section 6601(d) of the Code. Thus, if it is established that the original distribution by the corporation in 1952 resulted in ordinary income to the stockholder for such year, rather than long-term capital gain as reported on his income tax return for the year 1952, deficiency interest runs from the due date of that return. The interest thus determined is not includible in computing the decrease in tax for 1957 under section 1341(a)(5)(B) of the Code. See *Manning v. Seeley Tube & Box Co.*, 338 U. S. 561, 570, Ct. D. 1729, C. B. 1950–1, 113

To the extent that the original distribution received by the stockholder constituted a return of his basis in the stock, but to that extent only, the repayment of such amount will serve to restore such basis. For example, if the taxpayer had a basis in his stock of $1,000 and received a distribution of $10,000 in 1952 from a corporation which had no earnings or profits, the first $1,000 would constitute a return of the basis of his stock and the remaining $9,000 would constitute income. If, during 1957, the taxpayer was required to repay the entire $10,000, only $9,000, which previously had been included in income, could qualify as a deduction under section 1341(a) (4) or as an exclusion under section 1341(a) (5) (B) of the Code, and the remaining $1,000 would constitute a restoration of the basis of the stock.

Accordingly, on the facts here presented, as stated in the foregoing, it is held that the amounts repaid to the corporation by the stockholders constitute allowable deductions for 1957 under the provisions of section 1341 of the Code to the extent that they were reflected in gross income for 1952. Under such circumstances, the basis of the stock is restored, but only to the extent that such basis was previously applied against the amounts received in determining the gains reported for 1952. Further, interest, if any, paid or due on any deficiency properly determined for 1952, with respect to a stockholder, does not enter into the computation of the decrease in tax under section 1341(a) (5) (B) of the Code.

An organization which has been denied exemption from Federal income tax under section 501(c) (3) of the Internal Revenue Code of 1954 by reason of having engaged in a prohibited transaction described in section 503(c) (1) of the Code may not reestablish exemption until the loan which was the prohibited transaction has been repaid or adequately secured.

Advice has been requested whether an organization which has been denied exemption from Federal income tax under section 501(c) (3) of the Internal Revenue Code of 1954 by reason of having engaged in a prohibited transaction described in section 503(c) (1) of the Code may reestablish exemption before the loan which was the prohibited transaction has been repaid or adequately secured.

An organization, exempt from Federal income tax under section 501(c) (3) of the Code and subject to the provisions of section 503 of the Code, loaned a part of its corpus to a substantial contributor without the receipt of adequate security. The loan was evidenced by a promissory note maturing five years from the date of issuance. The organization was denied exemption because the loan was a prohibited transaction described in section 503(c) (1) of the Code. Thereafter, the organization filed a new application for exemption under section 501 (c) (3) of the Code with respect to subsequent taxable years. The application contained an affidavit by its president that the organization would not knowingly again engage in a prohibited transaction. The existing loan, however, had not been repaid nor had adequate security been furnished.

Section 501(a) of the Code provides in effect that exemption from Federal income taxes does not extend to an or-

ganization engaged in a prohibited transaction. Section 503(d) of the Code provides for the reinstatement of exemption to organizations previously denied exemption because of a prohibited transaction.

Section 1.503(d)-1 of the Income Tax Regulations requires such organization to sumbit a written declaration by a principal officer that it will not knowingly again engage in a prohibited transaction and to satisfy all other requirements under section 501(c) (3) of the Code. However, these regulations presuppose that, in the case of an organization denied exemption by reason of its having engaged in a prohibited transaction, the grounds for the original denial of exemption shall have been removed before an exemption may be reinstated for future years. Otherwise the organization would continue to be in violation of section 501(a) of the Code.

In this case, the transaction causing the denial of exemption carried into subsequent taxable years. Part of the organization's corpus was still loaned to a substantial contributor without the receipt of adequate security. Thus, the loan continued as a prohibited transaction. Accordingly, until the loan was repaid or adequate security for the loan received, the organization was not entitled to reestablish exemption under section 501(c) (3) of the Code.

Legal expenses incurred by a corporate officer in connection with his defense of criminal indictments for evasion of the corporation's income taxes and his individual income taxes are deductible as a business expense and a nonbusiness expense, respectively.

Advice has been requested as to the deductibility, for Federal income tax purposes, of legal expenses paid under the circumstances described below.

The taxpayer was secretary-treasurer of a corporation with the responsibility of filing the corporation's Federal income tax return. The taxpayer diverted substantial corporate funds to his personal use and did not report such amounts as income on either the corporation's income tax return or his individual income tax return. As a consequence thereof, he was indicted on two criminal counts, the first charging that he caused the corporation to evade its income taxes by filing a false and fraudulent tax return, and the second charging him with evading his personal income taxes by filing a false and fradulent individual tax return. The case went to trial and, as a result thereof, verdicts of guilty were returned on both counts. In connection with the trial and other tax aspects of the case the taxpayer employed counsel and paid legal fees for services rendered.

Section 162(a) of the Internal Revenue Code of 1954 provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

With respect to whether legal expenses are *business-related* and therefore deductible, or are nondeductible personal expenses, in *United States v. Don Gilmore et al.*, 372 U. S. 39 (1963), Ct. D. 1878, C. B. 1963-1, 355, the Supreme Court held that "[T]he origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense

was 'business' or 'personal' and hence whether it is deductible or not * * *." With regard to criminal cases, the *source of the criminal charges* or *the character of the conduct from which the charges arise* determines the deductibility or nondeductibility of the legal expenses in question. See *Commissioner v. Walter F. Tellier et ux.*, 383 U. S. 687 (1966), Ct. D. 1907, C. B. 1966-1,32.

The determination of the character of the conduct from which a given criminal charge arises or the source of such a criminal charge is dependent upon a consideration of all the facts and circumstances concerning the taxpayer involved. In this connection, consideration is given to, among other things, the acts committed or alleged to have been committed, their relationship to the taxpayer's business activities, how the taxpayer conducts those activities (for example, what acts, associations, relationships, and endeavors are involved in the conduct of the taxpayer's business activities), and whether being subject to the criminal offense charged was an inherent risk of engaging in the taxpayer's business activities.

Since, in the instant case, the taxpayer's duties included the filing of the corporation's tax return, the legal expenses incurred in defense of the charge of evading the corporation's income taxes by the filing of a false and fraudulent return arose out of or in connection with acts committed or omitted by the taxpayer in his trade or business as an employee of the corporation. See *Commissioner v. People's-Pittsburgh Trust Co.*, 60 Fed. (2d) 187 (1932).

Accordingly, legal expenses paid in connection with the defense of this charge are deductible by the taxpayer as ordinary and necessary business expenses under section 162 of the Code. Since the taxpayer is an employee, the

legal expenses are deductible only if deductions are itemized and the standard deduction is not used.

Section 212(3) of the Code provides that in the case of an individual there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax.

Section 1.212-1(1) of the Income Tax Regulations provides that expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with *any proceedings* involved in determining the extent of tax liability or in contesting his tax liability are deductible.

Although the final determination of Federal income tax liability is generally attained as the result of separate civil proceedings after the matter of criminal liability has been disposed of, ordinarily before such criminal liability can be established, there must be a determination and proof that a tax was due. Thus, proceedings dispositive of the charge of willful evasion of tax by filing a false and fraudulent return are related to the determination of Federal income taxes. See *Commissioner v. Michael and Rae Shapiro*; 278 Fed. (2d) 556, (1960).

Accordingly, legal expenses paid by the taxpayer in connection with the defense of the criminal indictment for evasion of his individual income taxes are deductible under section 212(3) of the Code in computing taxable income provided the taxpayer elects to itemize his deductions.

Enforcement of an employee's rights under a qualified pension plan is not within the jurisdiction of the Revenue Service; however, failure to make distributions pursuant to the plan will be considered in determining whether the plan retains its qualified status; Revenue Ruling 55-297 superseded.

Rev. Rul. 70-315

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the position set forth in Revenue Ruling 55-297, C. B. 1955-1, 393, concerning enforcement of an employee's rights under a plan that meets the requirements of section 401 of the Internal Revenue Code of 1954.

A participant in a trusteed pension plan that meets the requirements of section 401 of the Code was separated from the service of his employer after four years of service prior to attaining age 65. The plan provides that rights to benefits thereunder are vested in part for employees with four years of service who terminate employment prior to attaining age 65. The participant claims that he has been denied payment of his vested interest in accordance with the terms of the plan. He has requested the Internal Revenue Service to enforce his rights under the plan.

Section 1.401-1(b) (3) of the Income Tax Regulations provides that the law is concerned not only with the form of a plan but also with its effects in operation.

An employee's rights under a trusteed pension, profit-sharing, or stock bonus plan are governed by the terms of the plan and trust agreement and the applicable provisions of local law. The jurisdiction of the Service with respect

to such a plan is limited to determinations regarding (1) whether the plan meets the applicable requirements of the Code and regulations, (2) whether amounts claimed as deductions from gross income for contributions to the plan are allowable, and (3) the tax effect of distributions under such plans. In making such determinations, consideration must be given to the actual operation of the plan.

Accordingly, it is held that the enforcement of the employee's rights in this case is not within the jurisdiction of the Service. However, any failure to make distributions in accordance with the terms of the plan will be considered in determining whether the plan continues in a qualified status and whether contributions thereunder continue to be deductible under section 404(a) (1) of the Code.

Revenue Ruling 55-297 is hereby superseded since the position stated therein is restated under current law in this Revenue Ruling.

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-273

JOHN F. KAPPEL, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (Pet. App. 15a-32a) are reported at 281 F. Supp. 426. The memorandum opinion of the district court denying a motion for a new trial (Pet. App. 33a-36a) is not reported. The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 437 F. 2d 1222.

JURISDICTION

The judgment of the court of appeals was entered on February 1, 1971 (Pet. App. 12a-13a). A petition

for rehearing *en banc* was denied on March 19, 1971 (Pet. App. 14a). The petition for a writ of certiorari was filed on June 14, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether petitioners were not legally obligated to make repayments of amounts improperly withdrawn from certain pension trusts and, therefore, are not entitled to deduct the amounts repaid pursuant to Section 1341 of the Internal Revenue Code.

STATUTES INVOLVED

The pertinent provisions of Section 1341 of the Internal Revenue Code of 1954 are set forth in the petition (pp. 3-4).

STATEMENT

Petitioners [1] were officers, directors and principal stockholders of four corporations, each of which funded and maintained in Pennsylvania an employees' pension trust. Petitioners were also participating employee beneficiaries of the trusts. Together with their relatives, they constituted a majority of the trustees of each trust. (Pet. App. 3a-4a, 30a.)

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[1] References to "petitioners" are to John F. Kappel and William J. Kappel. Their wives are parties to this action only because joint income returns were filed for the year in issue. William J. Kappel died, and his executors were substituted as parties.

Under the trust plans, the trustees contracted for a separate annuity policy for each participating employee, including petitioners, through general life insurance companies. Each trust provided that benefits could not be paid to a beneficiary in one lump sum; that no beneficiary had any power of anticipation of the policy proceeds; and that no beneficiary could transfer an interest in the proceeds. (Pet. App. 4a.)

Despite these prohibitions, petitioners, on the advice of a reputed pension expert, withdrew from the trusts the proceeds of the annuity policies held for their benefit. The Internal Revenue Service determined, late in 1959, that these withdrawals constituted taxable income to petitioners, and they paid the additional taxes due on the income. (Pet. App. 2a, 4a-5a.)

Petitioners' legal and accounting advisers informed them that, because their withdrawals had violated the trust agreements, they were obligated to restore the funds to the trusts. Although no legal proceedings were instituted to require repayments, petitioners acted on this advice and, in 1960, repaid the amounts previously withdrawn. They claimed deductions for these amounts on their income tax returns for that year, in reliance on Section 1341(a) of the Internal Revenue Code. Insofar as pertinent here, that provision allows a deduction for an amount previously received under claim of right, which is restored, provided that events subsequent to the year of receipt show that the taxpayer "did not have an unrestricted right" to the amount received. (Pet. App. 5a.)

The Commissioner disallowed the claimed deductions on the ground that petitioners were under no

legal obligation to make the repayments. After paying the taxes in dispute, petitioners brought these suits for refund in the district court. That court sustained the Commissioner's determination (Pet. App. 30a-31a), and the court of appeals affirmed (Pet. App. 7a-11a).

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review.

1. If a taxpayer receives income under a claim of right and without restriction as to its disposition, he must include the income in his tax return for the year of receipt, even though he may be required to repay the money received in a later year. If in fact repayment is required, the taxpayer is entitled to take a deduction on his tax return for the year of repayment. See *North American Oil* v. *Burnet*, 286 U. S. 417, 424; *Healy* v. *Commissioner*, 345 U. S. 278.

Section 1341(a) of the Internal Revenue Code is the statutory successor to the so-called "claim-of-right" doctrine which this Court first enunciated in *North American Oil, supra.* The statute permits a taxpayer who qualifies for the repayment deduction either to take the deduction in the year of repayment, as under prior law, or to recompute, in effect, his income tax for the years in which funds were received, by excluding the amounts received from taxable income for those years. See *United States* v. *Skelly Oil Co.*, 394 U. S. 678, 680-682.

Under the "claim-of-right" doctrine as judicially formulated, and under its statutory counterpart, a

deduction is allowable only if, *inter alia*, there exists a legal obligation to make repayment of the amounts previously received under claim of right. Although it may not be necessary, in order to establish that repayment was required, that a court issue a judgment to this effect, a sufficient obligation must exist as would support a judgment. A voluntary repayment, or one sustained only by a moral obligation is insufficient. See, *e.g.*, *Crellin's Estate* v. *Commissioner*, 203 F. 2d 812 (C.A. 9), certiorari denied, 346 U. S. 873; *United States* v. *Simon*, 281 F. 2d 520 (C.A. 6); *Pike* v. *Commissioner*, 44 T.C. 787.

2. Both courts below correctly held that petitioners were not legally obligated to repay the funds which they had improperly withdrawn from the trusts. Under Pennsylvania law, such an obligation is imposed upon a beneficiary who consents to, or participates in, a breach of trust only if the breach results in a loss to another beneficiary. See *Quest's Estate*, 324 Pa. 230, 188 Atl. 137; Restatement of Trusts 2d, Sec. 256. Petitioners' unauthorized withdrawals in no way impaired or injured the interest of any other beneficiary, since each beneficiary's interest in the trusts was represented by a separate annuity policy.

The Pennsylvania cases upon which petitioners rely are not to the contrary.[2] In any event, there is no

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[2] *Union Trust Co. of New York* v. *Gilpin*, 235 Pa. 524, 84 Atl. 448, *Glauser Estate*, 350 Pa. 192, 38 A.2d 64, and *Maloney* v. *Glosser*, 427 Pa. 548, 235 A.2d 607 (Pet. 12-13), involved situations in which other beneficiaries had been injured by the breach. *Garner* v. *Girard Trust Bank*, 442 Pa. 166, 275 A.2d 359, and *Reilly* v. *Walker Brothers*, 425 Pa. 1, 229 A.2d

reason for review by this Court of the narrow question of state law passed upon by the courts below. Nor is there any basis for further review on the theory that petitioners might be liable as trustees for breach of their fiduciary duties. As the court of appeals observed (Pet. App. 9a-10a n. 8), such liability cannot give rise to a Section 1341 deduction.

3. Petitioners' remaining contentions are equally lacking in merit. Their claim (Pet. 19-26) that they were under a legal obligation to restore the funds because their failure to do so would jeopardize the tax exempt status of the trusts, was fully answered in the opinion of the court of appeals (Pet. App. 9a-10a). As for their suggestion (Pet. 18) of "an apparent conflict in decisions between the Third and Eighth Circuits * * *", it is sufficient to note that the case on which they rely (*First Trust Co. of Saint Paul* v. *United States*, 321 F. Supp. 1025 (D. Minn.)) was decided by a district court, and involves an estate tax question arising under Section 2039 of the Code.[3]

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457 (Pet. 11, 15), in which the court was asked to modify the terms of pension trust instruments, have no bearing on the question whether a beneficiary who consents to, or participates in, a breach of trust is liable to other beneficiaries.

[3] Petitioners erroneously state (Pet. 18) that the *First Trust Co.* case is now pending on the government's appeal. A final determination not to appeal was made on May 11, 1971, more than a month before the instant petition was filed.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1971.

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